PENSION PLAN ISSUES AND HOW THEY AFFECT SMALL BUSINESS

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PENSION PLAN ISSUES AND HOW THEY AFFECT SMALL BUSINESS

TUESDAY, JUNE 5, 1990

U.S. House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to call, at 10 a.m. in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. The Small Business Committee will come to order. The United States has developed a three-pronged approach for meeting the financial needs of our retirees—social security, individual savings, and private pensions. I think this approach makes sense, but I also believe that each of these three elements must be strong and generally available in order to assure an effective retirement system.

Therefore, I am deeply concerned that utilization of the Nation's private pension system seems to be decreasing. Formation of new plans has dropped significantly, while the termination of existing plans is increasing. These are disquieting trends.

Of equal concern is the fact that small businesses have lagged considerably behind their segments of the economy with regard to providing pension plans for their employees. In 1986 fully 91 percent of employees in firms with 100 or more employees were covered, while only 43 percent of those with fewer than 100 employees participated in a pension plan. The lack of coverage for tens of millions of employees does not bode well for them individually or for the Nation as a whole.

It is appropriate, therefore, that Congress review the incentives and disincentives that make up the present system. We should do what we can to encourage employers to offer pensions, and we should eliminate unnecessary roadblocks put in the way of the establishment or continuation of plans. Most importantly, we should be very careful about making further changes in a system which is already overly complex unless such changes are absolutely necessary. With this approach we may be able to find ways to improve coverage and thus help ensure financial security for our work force.

We asked our panel to address two specific issues that have arisen which are of particular concern to small employers. One is the proposal that we require joint trusteeship for workers and management for overseeing single-employer pension plans, known as the Visclosky amendment. The other is an IRS program which specifically targets small defined benefit plans for audits if they meet certain criteria. I will be interested in hearing our witnesses views on the wisdom and fairness of both of these matters.

In addition, we will be looking to the panel to provide us with their ideas on simplification of the pension system so more small employers can offer pensions; on proposals to increase the portability of pension benefits so increasingly mobile workers can participate in greater numbers; on regulation of the pension program; and on questions about the use of pension funds for mergers and acquisitions.

I look forward to hearing the views of our panel on these and related subjects, and I am hopeful that we will come away with some practical suggestions on how to make our generally successful pension system even more so.

[Mr. LaFalce's statement may be found in the appendix.]

At this time I would like to introduce into the record the opening statement of the ranking minority member of the committee, Representative McDade. With no objection, so ordered.

[Mr. McDade's statement may be found in the appendix.]

Chairman LAFALCE. We have a distinguished number of panelists today, and I think that they are lined up in alphabetical order, coincidental with ladies first, so why don't we proceed in alphabetical order with Ms. Nancy Altman.

TESTIMONY OF NANCY J. ALTMAN, VICE CHAIRMAN, ERISA ADVISORY COUNCIL, U.S. DEPARTMENT OF LABOR

Ms. ALTMAN. Thank you, Mr. Chairman.

Chairman LAFALCE. Ms. Altman, I may add, recently has been at Harvard teaching in both the Kennedy School of Government and the law school. She is a Radcliffe graduate, obtained her law degree from the University of Pennsylvania in 1982 and 1983. She was the executive assistant to Alan Greenspan when he was chairman of the National Commission on Social Security Reform.

Prior to that she spent time in the executive branch and here on the Hill in private law practice. She is presently vice chairman of the Department of Labor's ERISA Advisory Council and serves on the board of directors at the National Academy of Social Insurance. Ms. Altman.

Ms. ALTMAN. Mr. Chairman, thank you for giving me the opportunity to appear here today. In my written statement, I address in some detail all of the topics in which the committee has expressed an interest. In my oral remarks, though, I plan to limit my comments to just two of the topics, simplification and the IRS audit program.

I, of course, would be delighted to respond to questions on any of the subjects. Let me start with simplification. The goal of simplification is good, and in the abstract it is noncontroversial.

Nevertheless, I want to raise for the committee some cautions and limitations and concerns that I have.

Chairman LAFALCE. President Bush would have a simplification, good; implementation, difficult.

Ms. ALTMAN. That is right. I think that is a good summary. Let me try to fill it out a little bit. We have chosen to have for our retirement income system what I call a hybrid. It relies on social security as a floor of protection, then encourages employers to provide on a voluntary basis supplemental pensions.

The choice to have this kind of hybrid system rather than a single mandatory universal program, I think, is a very good one. It has a lot of strengths. It does have some weaknesses, however, and one of them is complexity results from a variety of factors.

It is more complicated than a unitary system would be. I detail in my statement the various factors which cause this to be true, but let me just mention one here. Because the private pension component of the retirement income system is voluntary and employers can choose not to participate if requirements become too burdensome, the Government must carefully balance the needs of employers, employees, retirees, and the public in structuring the rules.

In the effort to achieve equity and compromise among the parties, some of the rules become very complicated. For example, the coverage rules are quite complicated. You could have a rule that provides that an employer has to cover all its work force, which would be a very straightforward, simpler sort of rule, but of course it is more burdensome because of the current coverage rules and doesn't respond to the need for flexibility that many employers desire.

Some degree of complexity is inevitable, given the nature of the system. Nevertheless, as with any complicated statute, which has developed over time, there are opportunities for simplification. There is some unnecessary duplication that could be eliminated. There are inconsistencies in the statute, and so on. Nevertheless, there is a limit to what rationalization and neutral simplification of the rules can achieve. What I am concerned about is that in the guise of simplification some will cloak a substantive agenda. It will be ironic if proposals to try to simplify the system and expand coverage actually exacerbate a problem that I see as much worse than complexity. That is the frequency of change and concomitant uncertainty that we have had in the rules.

Between 1974 when ERISA was enacted and this year, there has been pension legislation every single year, but three. In two of the latter years in which there wasn't private pension legislation, there were major amendments to the Social Security Program, so employers still had to take cognizance of changes in Washington. Proposals for simplification hold the danger of prolonged uncertainty.

The complexity and frequency of changes, I think, can be blamed in part for the termination of existing plans and the slowdown in creation of new plans, but simplification is no panacea. It is not clear to me that even with greater simplification and stability in the system, and even with simpler and more flexible simplified employee plans that many employers, especially small employers, will be induced to form new plans.

Much of the complexity and cost can be avoided today simply by not taking advantage of some of the options available in the rules. For example, as I said earlier, if you cover your entire work force you don't have to worry about all the complicated aspects of the coverage rules. If you don't have an integrated plan you don't have to worry about the integration rules.

Notwithstanding its unclear impact, on expanded coverage and the caution about prolonging the uncertainty in the rules, I do think simplification makes sense in and of itself. To the extent it can reduce administrative costs, thus shifting freeing up funds for improved benefits that are now being spent on administration, and can reduce intentional or unintentional noncompliance, I think it will benefit the system.

Let me now turn to the IRS enforcement program. Although I don't believe there are widespread systemic abuses in our retirement income system, abuses obviously do occur, and I think it is of course important for the Government to remain diligent against self-dealing, breaches of fiduciary rules, and violations of the other rules in the private pension system.

It is in this capacity that the Government has chosen to target its enforcement activity against what has turned out to be predominantly small defined benefit plans. On its face, it may appear unfair to target enforcement on a subgroup in this manner. Nevertheless, I think targeting is imperative when resources for enforcement are limited. Every law enforcement agency in the country must target its investigations, and I think there is reason to focus efforts in the direction that the IRS has chosen.

What Internal Revenue Service has focused on are plans which have unusually large tax deductions per participant. According to the IRS, the average contribution per participant for defined benefit plans nationwide is $5,000. The IRS is examining those plans where the contributions are over $100,000 per participant. Indeed, the average for the plans examined to date is $215,000.

This extreme variance suggests the possibility of abuse—the use of pension plans to shelter income beyond what was intended by Congress. It is reasonable to anticipate that if large amounts of income are being improperly sheltered in this manner, it is going to be the small closely-held companies that are going to engage in this behavior.

They have the motive to do it and they have the opportunity to do it. Unlike large companies that have a pyramid structure with a large number of rank and file employees, many small firms will have several principal members and only a few clerical workers so that the bulk of the benefits will go to the highest-paid people.

In that case there is an incentive to maximize contributions to the plan since the owners will get the major benefit. This isn't true in a large firm. In a large company the incentive tends to be to minimize, not maximize, these benefits. The focus on small plans does not make the abuse any less real, though.

One of the chief reasons that the Government provides favorable tax treatment to qualified plans is to encourage employers to provide retirement income to low- and moderate-income workers. It is important that the Government prevent plans from being simply tax havens for the rich.

While investigation of these kinds of potential abuses could discourage plan formations and could result in terminations, they are still important to pursue. Pension arrangements which offer few or no benefits to the main low- and moderate-income workers, but cost the Treasury very substantial amounts in revenue loss, I don't think provide meaningful expanded coverage.

In conclusion, let me make just a few general points about the goal of expanded coverage versus other kinds of goals that we need to address. I agree with the chairman of the committee that expanded coverage is very important. The lack of coverage in today's retirement system I think raises very serious equity and adequacy questions.

Nevertheless, I think the goal of increased coverage shouldn't override, or trump, other goals of ensuring adequacy, equity, and security of the pension system. It is, of course, appropriate for policymakers to consider proposals for change in light of how they think employers will respond to them.

At the same time, employers can conveniently argue that they will opt out of the system if a particular expensive, burdensome, and otherwise unwanted change is enacted. Indeed, not surprisingly, if one reviews the history of pension reform going back to the 1940's, one finds that employers have threatened plan terminations every time a major change in retirement policy has been proposed.

I don't believe fear of plan terminations should cause policymakers to refrain from needed reform. At the same time, I believe the policy-makers should search for affirmative steps to try to expand coverage beyond its current levels, but I think it is quite difficult to do.

Additional tax incentives may be the most likely avenue of expanded coverage, but they are very costly, they may not work, and they are very difficult to target so the incentives don't merely provide a windfall to employers who would have otherwise provided pensions.

The best solutions, I think, might be to provide as stable an environment as possible, certainty in the rules, simplification where it can be done, continue a provision of employees with incentives to save on their own when they are not covered by employer-sponsored plans, and education of small firms about simplified employee plans and other relatively simple options. Thank you.

[Ms. Altman's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Ms. Altman.

Our next witness will be Mr. Donald Grubbs, an attorney, actuary, an author, a business man, and a consultant. He graduated from Texas A&M and Georgetown Law School where he served as an adjunct professor.

Mr. Grubbs was with the IRS when ERISA was enacted. He played a role in creating that landmark legislation. At the IRS he was the first Director of the Actuarial Division. He also served as chairman of the Joint Board for the Enrollment of Actuaries.

He has written extensively on pension-related matters, served as a consultant to several Government agencies and to the Senate Labor Committee and is a member of the Pension Reserve Council of the Wharton School of the University of Pennsylvania, but most importantly, Mr. Grubbs brings particularly relevant credentials to these hearings.

He is the owner of a small business, Grubbs and Company, which should make him uniquely qualified to comment on our concerns today. We are pleased to welcome you this morning, Mr. Grubbs.

I would like to point out, Mr. Grubbs, and to the other panelists, each of you has outstanding credentials, but I am going to regrettably ask each of you to try to keep your oral presentation to 10 minutes so we can have some time for dialogue among the panel and members of the committee.

TESTIMONY OF DONALD S. GRUBBS, JR., PRESIDENT, GRUBBS & CO., INC.

Mr. GRUBBS. Thank you, Mr. Chairman. My written comments address a variety of the issues that are on your agenda today, including the IRS audits of the defined-benefit plans, the proposal for joint trusteeship for pension plans, simplification in a very general way, and then, two, specific simplification topics, the quarterly contribution requirement and simplifying taxation of distributions. The views I express are solely my own.

I will confine my oral comments, though, to the IRS audit program. For defined benefit plans, the IRS has two responsibilities relating to plan funding, the minimum-funding requirements and the maximum deductible limits.

The purpose of the minimum-funding requirements is to make sure that employers contribute enough so that the plans are soundly funded. The purpose of the maximum-deductible limits is to make sure that people don't contribute too much so that they can gain a deduction just for the costs appropriately attributable to the particular year, because if they deduct more than that, they are not paying their fair share of taxes. What they don't pay, of course, either gets passed on to other taxpayers as higher taxes or results in the Government being forced to cut back on needed services.

In determining the costs attributable to a particular year, the actuary has to make assumptions regarding a variety of uncertain items—mortality, salary increases, retirement age, interest rates, and others. If the actuary were clairvoyant, he could make assumptions that would exactly reflect the future experience. But of course he is not clairvoyant, and so he has to make estimates of what that future experience is going to be.

The statute requires the actuary to use assumptions and methods which, in combination, offer the actuary's best estimate of anticipated experienced under the plan. The statute further requires that the actuary use methods and assumptions each of which is reasonable—taking into account the experience of the plan and reasonable expectations—or which, in the aggregate, result in a total contribution equivalent to that which would be determined if each such assumption and method were reasonable.

If the actuary uses assumptions that are too optimistic, the contributions will be insufficient to provide the promised benefits, but if the actuary uses assumptions that are too conservative, then the costs will be overstated and the deduction claimed will be too large and the employer will not pay its fair share of the taxes.

Of course actuaries have a difference of opinion about what future experience is going to be. However, there are limits to the range of what might be considered reasonable. Surely everyone would agree that an interest assumption of 15 percent or 2 percent would be unreasonable as a best estimate of anticipated experience.

Now, the reasonable expectations may vary from plan to plan. In a particular industry the average retirement age may be different than for the Nation as a whole, and a particular plan may be locked into investments where the expected return is substantially higher or lower than average.

Furthermore, the law doesn't require that these assumptions be individually reasonable if they are reasonable in the aggregate. For example, using an unreasonably low interest can overstate plan costs, but using a low assumption regarding salary increases tends to understate plan costs, so if I combine these two in such a way that I get approximately the same effect as if I had used individually reasonable assumptions, then the results are reasonable in the aggregate, and that is OK.

The IRS has a difficult task of determining when a particular plan has stepped outside the realm of reasonableness. This task is made much more difficult by the fact that there are 230,000 defined benefit plans, and the IRS has only a handful of actuaries in the national office who have expertise in determining the reasonableness of actuarial assumptions.

Most IRS auditors in the district offices are reasonably bright and conscientious, but they are not qualified to determine whether the assumptions are reasonable.

A significant number of small pension plans have been involved in the abuse of the tax system, using overly conservative assumptions as the basis for claiming unreasonably high deductions on their tax return. In my opinion, the claim of the 1980 deduction of $619,925 for the annual cost of the pension of Jerome Murza was an egregious example, and I am aware of other similar cases. At the same time, many plans are funded in a responsible manner using reasonable assumptions. The IRS has the task of sorting out tax abusers from the responsible taxpayers without placing heavy administrative burdens on plan sponsors.

As a means of meeting its responsibilities in auditing tax deductions, the IRS decided to focus on two areas of common abuse, the interest rate assumption and the retirement age assumption. In memoranda that they sent to the field, they stated that the auditors should not accept an interest assumption of less than 8 percent or retirement age assumption of less than 65 without approval from the actuaries in the IRS national office.

While some, including me, question the appropriateness of these particular assumptions, the general approach is appropriate. The IRS auditors have simple guidelines by which they could automatically conclude that many plans have acceptable assumptions and other plans using assumptions outside this range should be referred to the national office actuaries who are qualified to determine whether they are appropriate.

Let's look at the interest assumption. The assumed rate of total investment return, which includes interest and realized and unrealized gains, is generally called the interest assumption. What is reasonable in today's world?

We are not primarily concerned with the return in 1990. We are concerned with the rate of return from now until all of the present employees receive the last benefit that has been promised to them, although assumptions with respect to years beyond the first 30 years really have very little effect upon the plan costs.

For the overwhelming majority of plans, as a conservative estimate of what that is going to be, I think it is useful to look at returns on U.S. Government bonds. While pension plans usually invest most of their investments in other kinds of securities, these other kinds of investments which generally have higher returns than Government bonds—corporate bonds or stocks—and therefore the Government bonds provide a conservative basis for looking at interest rates.

The Washington Post reported last week on May 31 yields on 30-year Treasury bonds were 8.61 percent, and yields on these 30-year Treasury bonds have consistently been over 8 percent this year.

For the 10 years ending with 1989, the annual average yield on long-term Government bonds ranged from 8.14 percent to 13.02 percent, with an average yield of 10.56 percent.

The current yield of 8.61 percent represents the collective judgments of all of the people buying and selling these bonds on Wall Street. As usual, these yields on long-term bonds are currently slightly higher than the yields on intermediate and short-term bonds. In any period in which investors think that long-term rates are going to fall, the opposite is true. What this shows is that presently the collective judgment of Wall Street is that there is no expectation of significant drop of interest rates in the long-term future.

As indicated earlier, the alternative forms of investments, corporate bonds and stocks, generally have higher rates of return. These Government bonds not only represent what you can invest in today's assets conservatively, but they are also the collective judgment of the marketplace as to what interest rates are going to be in the future.

In light of these and other considerations, in my opinion it's currently unreasonable to use an assumption of less than 8 percent as a reasonable estimate of interest.

I don't use less than 8 percent to determine contributions to any of the pension plans for which I am responsible. I believe it's appropriate for IRS to restrict automatic approval to those plans which use an investment return of 8 percent or more.

Plans that use lower interest rates can refer the matter to the IRS actuaries in the national office, and they may show a valid reason why a particular plan either might have a lower return than the average for some reason or why a lower-interest assumption would be justified because they have used a low-salary assumption and this low-interest assumption offsets a low-salary assumption. So there could be justifications which the actuaries could determine as reasonable.

My written paper addresses two other assumptions which I will speak about briefly. One is the use of the interest rate in determining the amount of benefits under the plan. We use interest rates in pension plans for two different purposes. One is in this actuarial valuation to determine what the plan is going to earn in the future, and the second is to determine the amount of benefits to be paid which are actuarially equivalent.

For example, the pension plan has promised John Doe that when he is 65, he can receive $1,000 a month for life, but it also says alternatively that he can take a lump-sum distribution equal to the present value of that monthly pension, using assumptions that are in the plan document as required regarding interest and mortality. The plan document may typically say for this purpose you have to use a specified mortality table and perhaps 6 percent interest. If the plan document said that, John Doe, instead of getting $1,000 a month, could receive $112,142 as a lump sum distribution. It would be a violation of ERISA for the plan to pay him any other amount.

We have a problem. An IRS notice has said that beginning in 1991 we have to assume that the plan document didn't say what it said, to assume that the plan uses the same interest rate to determine lump sum distributions as the interest rate used for the discounting purpose in accordance with in the statute for this purpose. Typically 8 percent is used for that purpose. So if one follows this IRS notice, one would be forced to assume that this lump-sum distribution is only about $98,000, even though the plan must pay $112,000 and it would be a violation of law for it to pay anything else. This is absurd. It's fundamentally unsound. It undermines the sound funding of pension plans.

I also addressed the retirement age assumption where the IRS has said that assumptions lower than 65 should be referred to the national office. We know, in fact, that most workers in America now retire at 62, and why shouldn't 62 then be an automatically approved assumption? That's the age most people, in fact, retire, and so IRS is erroneous in using 65 rather than 62.

There is much more I could say, and I would be glad to respond to questions. Thank you.

[Mr. Grubbs' statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Grubbs.

Our next witness is Mr. Leon Irish. Mr. Irish is a Stanford undergraduate, has a University of Michigan Law School degree, and a Doctor of Philosophy from Oxford.

He was a law clerk to U.S. Supreme Court Justice Byron White. He is a successful attorney and partner in the distinguished Washington firm of Jones, Day, Reavis & Poque. He has served as chairman of the Employee Benefits Committee of the ABA's Tax Section, and chairman of the ABA Joint Committee on Employee Benefits.

I would note that when I first met Mr. Irish, it had nothing to do with pension plans, but it had to do with the development of emerging democracies in Eastern Europe, an interest that we share.

Mr. Irish, it's a special pleasure to have you with us this morning.

TESTIMONY OF LEON E. IRISH, PARTNER, JONES, DAY, REAVIS & POQUE

Mr. Irish. Thank you, Chairman LaFalce. It is my pleasure to expand the area of our common interests to include pensions for small business, as well as Eastern Europe. I would just add that the views I express are strictly my own and should not be attributed to my firm or my clients.

I am going to try, having submitted the longest of the written statements, to make the shortest oral presentation. I want to——

Chairman LaFalce. Have the best of both worlds.

Mr. Irish. I would like to present to the committee the highlights of some concrete proposals I have made with respect to portability and joint trusteeship, and then offer some perhaps critical thoughts on the process and juris prudence aspects of the small plan audit problem.

My proposal on portability is easily said. I would advocate that this committee seriously consider repealing income averaging for distributions from pension plans and repeal lump-sum distributions for all purposes, including for retirement distributions, saving only death distributions as possible lump-sum distribution candidates.

The problem that this set of changes would solve is one of the key portability problems. Two-thirds of portability losses, according to the Department of Labor, come from the mere fact that lump-sum distributions are not rolled over. The potential for a tax free roll-over is there, but over 80 percent of lump-sum distributions are spent rather than saved, even when the participant has to pay a penality.

I would make an exception for supplemental savings plans, namely defined contribution plans where there already is an adequate defined benefit pension plan or other retirement plan in place. I would allow lump sum distributions from such supplemental savings plans.

There are a couple of other problems. One is, if you do not allow distributions when an employee leaves, the employer is burdened with maintaining small accounts. There is the special defined benefit plan problem that Nancy Altman mentioned. A deferred vested pension benefit actually erodes in real value when it is paid out at retirement but based on the salary at separation from service date.

To address these problems, I would adopt and recommend to this committee the proposal made nearly 2 years ago by my copanelist and respected friend, Don Grubbs.

In excellent testimony on July 12, 1988, to the Oversight Subcommittee of Ways and Means, he proposed a Federal pension portability fund. I would make some changes in his proposal and would therefore call my suggestion a National Employees Savings Trust [NEST]. I would mandate that all pension plans permit employees to roll their pensions over to the NEST when they leave one job to go to another.

In that NEST, these partial pension amounts would build up as defined contribution amounts. Even former defined benefit pensions would build up in value. I would advocate that those moneys be managed by the private sector, that the costs of administration be borne by the fund, and that payouts from the NEST be permitted only as retirement annuities, as a cash refund, single or joint life annuities.

Moving quickly to joint trusteeship, I think that Congressman Visclosky has proposed the wrong solution to a very real problem. The strong, negative reaction of the business community to his proposal suggests the old adage that where there is smoke, there is fire.

I think there really is a serious problem of partisanship or bias in the management of pension funds, but to add a labor or employee representative would merely further politicize pension management and create pressure for impermissible social investing, investing of pension funds not to produce the greatest fund and benefit for the plan but, for instance, to create or preserve jobs.

Investing pension funds for such purposes is, according to the Labor Department, impermissible. I think the Department is right. There is a serious existing problem of employer bias, but I want to be very clear that I am not charging illegality or impropriety.

The old adage that where you sit determines where you stand simply informs us that human nature being what it is, people tend to favor the employer for whom they work. We see this in the investment of employer managed funds in investments, voting, and benefit claims.

Although most pension plans, especially those of large employers, we independent investment managers, see some employer-managed pension funds being invested in suppliers of customers of the employer, in acquisition targets, or for windows into new technologies.

We see employers having their officers and employees voting or tendering shares of the company that are held by the pension plan. We see benefit claim disputes being resolved by employees of the employer—in effect, the employer sitting as judge and jury in a dispute in which the employer often has an indirect, if not direct, interest.

I think we need to get rid of employer trustees and fiduciaries in pension plans when there is a conflict of interest, and the way to do that is a simple and outright repeal of section 408(c)(3) of ERISA.

Section 406 forbids any fiduciary of a plan to engage in self dealing, to act in the interest of another, or to receive any consideration from another in a transaction dealing with the plan. But section 403(c)(3) says none of those rules are implicated merely because the fiduciary is an officer employee, or other agent of the employer.

I think we know enough about human nature, and now ought to be candid enough to admit that employees cannot wear two hats at once and still act for the exclusive benefit of plan participants. We ought to repeal section 403(c)(3) and thereby preclude officers and employees of the employer from serving as fiduciaries in all conflict situations.

This would lead to their not being able to serve as investment managers, not being allowed to vote the stock held in pension plans, particularly employer stock, and not being able to administer benefit claims procedures. I would certainly allow the employer to continue to do the ordinary administration and record keeping.

The question, of course, for this committee is whether a proposal like this makes sense for small business. I think that there are reasonable alternatives to self trusteeship, even for small plans, but this committee would certainly want to study this proposal to be sure. At any rate, I think repealing section 403(c)(3) is the right answer to the question that Mr. Visclosky has rightly raised but wrongly answered, and I would recommend such a repeal to the committee.

On simplification, I share many of Ms. Altman's views and have attached to the written testimony an article on simplification that

I wrote nearly a dozen years ago. The message of it is that simplification is not as simple as it sounds.

On small plan audits, you will see on page 26 of my written remarks the offending paragraphs which triggered this whole heated dispute. The apparent directions to the field to challenge every interest rate under 8 percent and every retirement age under 65 have caused ASPA, the American Society of Pension Actuaries, to accuse the IRS of engaging in an illegal and abusive program against small defined benefit plans.

The issue is far more complex than ASPA's attack would suggest. I have tried in the written testimony to lay out some of the key background. In particular, I have attached to my written statement a recent letter from Assistant Commissioner Brauer, including a fairly lengthy memorandum which seeks to set forward the background and facts on this issue from an IRS perspective.

What emerges is that this is a complex issue. However, I think that the IRS can be rightly criticized for having allowed the problem to go on as long as it has and to develop to the extent that it has.

There are now several hundred thousand defined benefit plans for five or fewer participants, many of them covering high-income individuals who are claiming deductions or have claimed deductions in the hundreds of thousands of dollars each year.

I think that the IRS knew or should have known that this problem was growing and should have taken a public position to warn people of this problem and steer them clear of it.

Now that the problem is there, I would urge this committee and Congress at large to allow the IRS and courts to handle it. I think oversight is appropriate for Congress. I think it is not appropriate to intrude into the process by which the administrative agencies and the courts handle these issues.

I think the legislation that Senator Boschwitz has proposed, artfully drafted as it is, would constitute such an intrusion, and I would recommend that this committee not pursue such an intrusive approach.

There is much more in my prepared remarks, but I will stop with that. Thank you very much for the opportunity to be here.

[Mr. Irish's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Irish. Our next witness will be Mr. Dallas Salisbury, head of the Employee Benefit Research Institute which he founded.

The Employee Benefits Research Institute is an unparalled source of informed and unbiased data, information and advice about employee benefit issues of all kinds, and Mr. Salisbury's leadership has had much to do with their great reputation.

Prior to the formation, he was the executive director for Policy at the Pension Benefit Guaranty Corporation and Assistant Administrator for Policy and Research of the Pension and Welfare Benefit Programs Administration in the Department of Labor.

Mr. Salisbury, we are very pleased you could be with us this morning.

TESTIMONY OF DALLAS L. SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. SALISBURY. Mr. Chairman and members, it's a pleasure to be here.

I would try to be even briefer than my colleague, Mr. Irish, and I shall try to refrain from the temptation to ignore what I came to say and respond to what he said instead.

Chairman LAFALCE. We will give you ample opportunity to do that.

Mr. SALISBURY. One of the issues raised in your invitation letter was a question related to the status and strength of the American pension system, and there has been some press attention recently to that issue, as you well know.

I would just stress momentarily that in terms of absolute numbers, the employment-based pension system today covers more individuals than at any time in our history, more individual workers are participating than at any time in our history, more individuals by far are vested with irrefutable and retrievable rights to benefits, and more individual retirees are receiving benefits at a higher percentage rate than at any time in our history.

The system is better funded than it has ever been. The vast majority of the plans are, in fact, overfunded for the benefits that have currently been promised, whether they be single employer or multiemployer plans. We are looking at a system that is very, very strong.

In small business, we see some unique characteristics. Plan coverage among small business has also been relatively low. I suggest to you that reform in 1986 that dramatically lowered tax rates and subsequent changes that dramatically reduced the amount that small businesses could put into pension plans, combined with very short investing schedules, have sufficiently affected the decision-making of small businesses that we should not expect in the current environment any significant increase in small business coverage with or without simplification or other changes.

Simplification—interestingly the ultimate form is no rules whatsoever. I am sure that that is not an acceptable alternative. If it is instead that we are going to have a system of detailed rules, simplification is the enemy of flexibility and diversity.

Large business prefers flexibility and diversity. Small business would prefer the clear, straightforward rule that doesn't take a band of lawyers, accountants, actuaries, and others to help them say what it means. I would suggest that we will stay in a nonsimplified world regardless of what the ideal outcome would be.

On joint trusteeship, another issue raised, we have clear evidence from the public pension plan environment and the multiemployer plan environment that joint trusteeship can, in fact, work. It can work to provide benefit security and reasonable rates of return.

Having said that, the data clearly indicates that nonjointly-trusteed plans have had significantly higher historical rates of return than jointly-trusteed plans as a result of different decision-making on investment allocation.

That interprets in the historical view over the last 20 years that jointly-trusteed plans have produced rates of return that if imposed on the single employer system, would have required contributions on average 40 percent higher than what was contributed to those plans, with significant overall compensation expense and Federal revenue loss implications. So it is workable. But, there are very clear tradeoffs.

In terms of portability, the third issue raised in your letter, I would note that the lead-off concern, mobility in the work force, is not, in fact, up on any historical level.

We have the sense of high mobility because the baby boom generation has been so large. But the mobility rates within age categories are the same for the baby boom as they have been for the generations before them. So I would underline that while mobility may be a prospective issue, there is no statistical evidence to indicate that it is a dramatic issue today.

In the pension system, post-ERISA reforms have tended to highlight turnover because we have very short vesting. We have age 21 participation. We end up being more concerned about turnover at these very young ages where we were not as a historical matter.

If we look at the issue of portability, all of the data indicates that if anything, and Mr. Irish made reference, if anything, we have too much portability in the current pension system.

Nearly 100 percent of defined contribution plans pay lump-sum distributions upon termination of employment. Based on the most recent Census Bureau data, 13 percent of participants that received a lump sum chose to roll that money over, and the balance chose to pay immediate taxes on it.

Portability leads to dissipation of billions of dollars of annual distributions by workers who would otherwise go to retirement income.

As the Department of Labor's recent report and Secretary of Labor Dole's recent statements indicate, that is the principal leakage that should be dealt with.

In other words, I would suggest that Congress has much to do on the issue of pension preservation before it worries further about pension portability. In terms of system safety, I would end where I started. The system is very strong, plans are well-funded, the PBGC system of guarantees is strong and well funded.

The Tax Reform Act changes of 1986, and the OBRA changes of 1987 have severely limited the potential of future abuses vis-a-vis the pension guarantee system. While there clearly are areas where more action may be needed, while there is clearly the necessity of strongly enforcing the law and providing the agencies the necessary resources and support to do that, I would simply disagree with some of the generalized statements of prior testimony and stress that the vast majority of pension plans are run responsibly, professionally, and to a very large degree independently. This is an area where we should not allow analogies to S&L crises and horror stories to lead us in directions of additional legislation that would ultimately damage the entire system. Thank you, Mr. Chairman.

[Mr. Salisbury's statement may be found in the appendix.]

Chairman LaFalce. Thank you, Mr. Salisbury.

Our final witness today is Mr. Roy Schotland, a professor at the Georgetown University Law Center, where he has also served as associate dean.

Professor Schotland went to Columbia, Oxford, and Harvard Law School. Like another of our witnesses today he, too, served as a clerk at the U.S. Supreme Court, which Justice was it?

Mr. **Schotland**. Brennan.

Chairman **LaFalce**. In addition to Georgetown, he has taught at law schools of the University of Virginia and the University of Pennsylvania. He is a prolific author, and his works include a major study on pension fund investing. In addition, Professor Schotland has consulted to numerous public and private retirement plans both here and abroad.

Mr. Schotland, thank you very much for being with us this morning. Please proceed.

Mr. **Schotland**. May I ask, does the minority always have three members to balance you?

Chairman **LaFalce**. They need a lot more.

TESTIMONY OF ROY A. SCHOTLAND, PROFESSOR, GEORGETOWN UNIVERSITY SCHOOL OF LAW

Mr. **Schotland**. Mr. Chairman and members, I limit my testimony to the first matter on which comment was requested, the pending proposals that employee representatives comprise half of a pension plan's board of directors. It has been asked who is afraid of the lunch pail trustee? So far, afraid or flatly opposed are a large majority of the U.S. House, and apparently an unbroken chorus of pension people affiliated with corporate sponsors.

On the other side, supporting Congressman Visclosky's proposal we have had an array of labor leaders and academics. As so often here we have a noble goal and a blunderbuss proposal to attain it, provoking brick wall opposition on both sides, overblown rhetoric and a range of only marginally relevant facts.

As Lee Irish said, rarely has a proposal caused more heated debate. Surprisingly, no one has spoken out for participant representation on the one hand, but against the extreme of joint representation on the other. Rather than yet again repeating the pros and cons of that proposal, allow me to focus on eight points as lean and rhetoric-free as I can put them.

Point one, multiemployer plans with joint boards are so different from corporate plans in so many ways that we should put aside the differences and focus on the issue before us, whether we think the current governance structure of corporate plans is ideal or can be improved.

Point two, public plans are also, of course, very different from ERISA-covered plans, but the fact that their boards are diverse with some assuring some participant representation, sometimes joint boards, surely calls into question ERISA's procustom treatment of joint boards for multis, zero participant participation elsewhere.

Point three, ERISA-covered pension assets must by law be managed for the exclusive benefit of retirement security. Since the pension liability is the sponsors, it is understandable that control of the assets remains and should remain the sponsors.

Point four, given the primacy of the exclusive benefit goal, it is surely questionable, and I find it inconsistent and foolish, or at least anomalous and self defeating, that the people whose exclusive benefit is at stake are entirely excluded from plan governance.

Point five of the eight, battling about control and joint representation is a red herring. The real question is whether pension plans would gain or lose if participants had some role in their governance. ERISA is loaded with provisions to prevent conflict of interest abuses and to assure adequate disclosure, but nothing in the plan's governance structure helps meet those concerns.

Indeed, ERISA disclosure, though today's time limits bar developing the point, has been monumentally ineffective, even wasteful.

Point six, if participants have some representation on plan boards, there may or may not be better investment or other changes, but there will be two certainties. Plans' boards will be more aware of participants' views, participants will be more aware of their plan's operation and strengths or weaknesses. Plans that are well run have nothing to lose and are likely to produce greater employee satisfaction. Plans that are less well run will enjoy one more mechanism pushing them toward shaping up.

Next to last, point seven, every ERISA-covered plan above x size should have on its board at least one or two participant representatives, and also at least one retiree representative unless retirees are included in the process of selecting the participant representatives.

Rather than trying once again to perfect the world by close-of-business tomorrow, I suggest phasing this in. As for how representatives should be selected, we can set several models and let sponsors pick whichever fits best.

Point eight, since defined contribution plans impose all investment risk on participants, there the case for including participants in governance is obviously stronger. Indeed, there the lack of their representation is indefensible. Certainly it exists only because ERISA generally gives so very little attention to defined contribution plans. For them, at least about one-third of the board should be participant representatives. Retirees do not need to be represented there because they have little or no continuing interest in those plans.

To sum up, two points. Small business pension plans are bound to be fewer and weaker if the private pension system generally fails to command widespread popular support. That support is bound to depend primarily on how well such plans provide benefits, but it undeniably depends in part on whether private plans are managed purely paternalistically.

Point two, giving participants and retirees some role in governance will raise none of the concerns provoked by the pending proposal mandating joint boards, but it will assure the two obviously needed corrections. Participants' retirement security will be managed with their views on the table and participants will be far better informed of how their plan is being managed.

The current governance structure of corporate plans is a paternalistic relic of the era when a career of service ended with a gold watch. At least, since 1974 pensions are not gifts. Can plans really be managed for the exclusive benefit of participants as our legislated litany rightly requires if their governance completely excludes participants? Thank you.

[Mr. Schotland's statement may be found in the appendix.]

Chairman **LaFalce**. I want to thank you very much. I consider this to be one of the finest and most distinguished panels that has appeared before me on any subject since I have been a Member of Congress on an exceedingly complex area of the law.

I am tempted to start right in with the questions on my mind, but I think I should take advantage of the expertise of this panel to first ask the panelists if any other members of the panel said something that you thought was particularly worthy of support or particularly egregious and worthy of refutation.

Mr. **Irish**. You left out mildly egregious statements.

Chairman **LaFalce**. Or even if you just wish to join issue without it being egregious, OK? Is there anything on which you would like to clearly—Mr. Grubbs?

Mr. **Grubbs**. On the joint trusteeship issue, while I am sure it was well intentioned and it sounds benevolent, I feel it would be very harmful to participants. I think plans need professional——

Chairman **LaFalce**. Are you talking about the Visclosky amendment or are you talking about repeal of section 403(c)(3) or are you talking about Professor Schotland's participation as opposed to representation proposal?

Mr. **Grubbs**. I am talking particularly about Mr. Visclosky's proposal, but to some extent about Mr. Schotland's remarks as well. I think plans need professional investment management. That is why I ordinarily recommend a bank as the trustee to hold the funds and the bank registered investment——

Chairman **LaFalce**. As we look at the financial landscape today, some would say that is not too professional, but please proceed.

Mr. **Grubbs**. With either the bank or a registered investment advisor as investment manager of the fund. Alternatively some funds get this institutional safeguarding and investment management under a group-annuity contract with a life insurance company, or you can get it through no-load mutual funds. But in most companies, there is neither a representative of management nor any employee who has adequate investment knowledge, or the resources to hold, safeguard, and invest plan assets. Investment policy and investment decisions, I feel, need to be made by people who are competent to do that.

Then you have a variety of other problems with this proposal. One is that there are a lot of plans in which there is only one participant, the owner of the business, and Mr. Visclosky apparently would require joint trustees to represent the companies and employees, an absurdity in this situation.

In a little business, it doesn't make much more sense. We have a business that includes a plumber and his helper. The plumber owns the business. The plumber's helper probably doesn't want to be a trustee, knows nothing about investments; he doesn't want to learn about it, and if he understands anything about fiduciary responsibility and cofiduciary responsibility, he certainly doesn't want to take on the role. What should a plan do? No employee wants to take on the role or is capable of taking on the role.

Fourth, on the misuse or abuse, I have seen far more situations of actual abuse or misuse of plan assets where there are individual trustees than I ever have where there is a bank trustee.

Chairman LaFalce. Do other members wish to comment on any issue any other members on the panel have made?

Mr. Irish. If I could second Don Grubbs' thoughts on that, I would likewise oppose Professor Schotland's proposal, as well as Mr. Visclosky's. I think we need to increase the competence and decrease the inherent bias of people in charge of pension plans. I think we need to move it out of the hands of people who work for the employer or who are union representatives and get it over to independent professional managers.

Chairman LaFalce. What about the employers' argument the employer is going to bear the entire risk of an under-performing fund, and therefore, the employer——

Mr. Irish. They should be very careful in selecting the money manager, and I think they will do better if they go to professional money managers and switch managers when one is not as good as it should be.

There are different functions, though, and we need to think differently about each of them. For instance, administration, recordkeeping are largely ministerial and could stay with the employer.

Chairman LaFalce. If the employer has this inherent and absolute right to terminate the trustee at will, isn't there effective and absolute control over the trustee, and isn't that tantamount to still having the employer as trustee?

Mr. Irish. It is a good question. If the only job I have is serving as money manager for your pension plan, and you have the right to fire me at any time, I may well be subject to quite a bit of influence from you, the employer.

If I am managing 1,000 pension plans, however, I am simply not going to be swayed by the desires of one. My job is going to be to establish a professional reputation and attract clients on the basis of my ability to perform professionally. That is what is out there in the world. We have well-respected, highly-professional fiduciaries to serve in this capacity, and I think we should get the inherently biased and often incompetent people out of it.

Mr. Salisbury. I am troubled even by the implication of the last statement, plus a number of things in the written statement.

Chairman LaFalce. Of who, Mr. Irish?

Mr. Salisbury. Of Mr. Irish.

Chairman LaFalce. Maybe I shouldn't seat him next to you.

Mr. Salisbury. By the implication of the blank statement, that implies there is this rampant absence of professionalism and making statements that imply that it is generalized in the pension system that members of management are in fact managing the pension funds, which is not in fact what is happening out there.

The number of cases, percentage of assets or percentage of plans where members of corporate management or unions are making the management decisions, per se, are minute. The majority of pension plans—by far, the majority of assets, are situations where independent investment managers are selected by the organizations. They are most frequently selecting outside banks or mutual funds companies or others to serve in the roles that have been identified as being undertaken by management.I think that needs to be underlined. There are clearly situations that apply to what Mr. Irish is saying, but I think it should be emphasized they are by far the minority of situations in the system, they are not the common rule of the system.

I go to the next step to focus momentarily on the comments about Mr. Visclosky's proposal, and I dare say that at the risk of putting words in his mouth, that he probably at times wishes his name had never been attached to the proposal, given the types of things that have been said about it this morning.

Mr. Visclosky has been very actively out talking with organizations, raising issues that go far beyond the issues that have been raised by the witnesses here today, and in negative statements about his proposal in terms of making it clear he has tremendous views of flexibility and how this should be structured, and making it clear per Mr. Schotland's comments—that the issue is employee representation and process and not employee control, if people will talk about that, and I have trouble, wherever it comes from, of gross overgeneralizations, generalizations and the concept—whatever the general merits of Mr. Visclosky's proposal of joint trusteeship of using the example of a plumber with one helper, as the example of why this is bad, when the number of such situations that can probably be found where pension plans even exist, when among employers of less than five employees no more than 3 percent have pension plans, period, and most of those are doctors and lawyers, not plumbers, is that it is almost the red herring argument.

I would simply support Mr. Schotland's statement that we should deal with these issues on substance and on fact, not with gross overgeneralization.

Mr. **Irish**. If I can respond, I think Dallas will see that we have no disagreement with respect to the management of the generality of pension assets for large employers. I have made that clear in the statement.

There are a number of big and small plans, however, where the investments are in fact managed by employees or officers of the company. Far greater are the number of plans in which benefit plans disputes are adjudicated by employees of the employer, not by independent fiduciaries, and if we turn to ESOP's and other stock-funded plans, many employers retain the right to vote, or direct the vote, of the stock in those plans.

I think the repeal of section 403(c)(3) is the way to eliminate those inherent conflict-of-interest situations and to get to more competent and more neutral trustees, which ought to be the aim, not to multiply the number of fiduciaries with inherent bias.

Mr. **Salisbury**. I would only comment if we are defining as management for your purposes, the professional money managers, for lack of a better example, GTE Investment Management, which is an independent money management unit, runs the pension assets of GTE's pension plans, and that those managers, in quotes, are individuals all of whom came out of the profession of independent money manager, and who select then other money managers, if we are defining those individuals as members of management, then there may be some substance.

I tend to view those individuals and clearly, by their membership in the Financial Analysis Federation and other organizations, they view themselves as investment professionals. They don't view themselves as members of corporate management, whose management responsibilities are the business of running GTE versus running the pension assets that happen to belong to that pension fund.

An increasing number of those wholly-owned subsidiaries are also managing assets of other companies' pension funds. In that structure, it becomes very much a matter of semantics and definition, I would agree, but always given the tendency—I point to yesterday's Wall Street Journal and last week's New York Times—the tendency to pick up a statement and generalize it to the entire system, is the reason I am making the point, and it relates as well to ESOP's.

The data on most of the ESOP's being created in the last few years is those ESOP's and the amendments of existing ESOP's are now turning the proxy voting responsibilities to the employees. It is a very clear trend, and by our expectations in the employees stock ownership trend, that will be the general rule in ESOP's rather than the exception.

That doesn't mean there may not be some ESOP's where your point is well-taken, but it should be clearly understood it is again not the general rule, it is a case-by-case situation. We need to look at it with that kind of detailed analysis.

Mr. **Irish**. Don't you think, Dallas, that we would be better off if we got rid of the general rule of section 408(C)(3)?

Mr. **Salisbury**. I am not expressing much concern about your proposal, as about some of the statement you are using that——

Chairman **LaFalce**. We are going to have to go on. I will give Ms. Altman and Professor Schotland an opportunity to comment.

Ms. **Altman**. I think part of the reason behind the disagreement on the panel is also the reason congressional policymakers generally are having trouble grappling with these issues.

Chairman **LaFalce**. There are few issues.

Ms. **Altman**. I understand, and that is my point. I lump with joint trusteeship, although you may find it surprising, a whole host of issues, including corporate takeover issues, voting proxies, social investment, and asset reversions.

I think what has happened is that we have in some ways an outmoded framework for thinking about all these issues. The world has changed dramatically since the trust model and the fiduciary rules were first applied to pension plans.

Those rules tend to focus on abuse. I agree with Mr. Salisbury, these aren't issues of abuse. Rather, there has been an explosive growth in the size of pension funds that has an enormous impact on the economy.

My problem with Rep. Visclosky's amendment, is that it doesn't address the whole problem. Beyond the issues of employer-employee relationships, there is a very strong public interest in the management of these funds and the way they are invested and so forth. I think what we need to do is to have more creative thought about what the third-party public interest is in these funds. I wish I had a solution. I am only posing the framework.

Chairman **LaFalce**. Professor Schotland.

Mr. **Schotland**. I believe in creative thought. I also believe we have solutions before us. Dallas Salisbury was good enough to seem to support what I have said, and I ought to support him, because of not only reciprocity, but also I think he is right in his description of the universe. I have a conflict of interest, though, which makes me wish I thought Lee Irish were righter than I think he is.

Bear Stearns, a dynamic firm, has a major subsidiary, of which I am a director, which stands ready to serve as an independent fiduciary and wholly apart from the fact they have things to say, I really think you could render a great service here to small business if you were to hold a hearing on pension consultants.

I think the people whom Lee Irish is suggesting ought to have an even larger dominance in this sector are not without problems, and I think we have seen that in the Executive Life situation, where an absolutely major firm did nothing but look up the rating on an insurance company so far as has emerged publicly yet, anyway.

With respect to the issue that both, I thought my friends, Grubbs and Irish here took on, what I thought was a modest proposal as you put so well for participation, a fellow wrote a book about the autocrat at the breakfast table, I think we have here the autocrats at the witness table.

The proposition that corporate management can't control its assets responsibly if one or two participant representatives are sitting there making sure we do have the kind of professionalism we want, making sure they are paying attention and do have the legal requirements of exclusive benefit in mind—I find the positions taken just astounding, and Dallas called Don Grubbs' point about the single person plan absurd, and I don't know what other word——

Mr. IRISH. Roy, what do you think about employers running claims dispute procedures using their own employees?

Mr. SCHOTLAND. Perhaps we can segregate the management of the assets from the administration of the claims.

Mr. IRISH. What they do is typically have independent fiduciaries run the money, which is fine, but they typically run the benefit claims procedures in-house.

Mr. SCHOTLAND. No; they don't have the independent fiduciaries running money with them having completely signed off. They have to watch those fiduciaries.

Mr. IRISH. What about the claims procedure?

Mr. SCHOTLAND. I repeat, we can segregate that.

Chairman LAFALCE. I ask such great questions, don't I?

Mr. SCHOTLAND. Mr. Chairman, I have heard that the special gift of the able politicians is to be able to bring people together. You have also the gift of——

Chairman LAFALCE. I think this dialogue has been stimulating and enlightening.

Mr. SCHOTLAND. That is what we try to do in law school.

Chairman LAFALCE. That is right. But can I pass?

Mr. SCHOTLAND. Absolutely, pass.

Chairman LAFALCE. I have an awful lot of questions, but I will refer to Mr. Hiler.

Mr. HILER. I thank the chairman for his generosity. I must say, not having been here for the entire hearing, having read most of the testimony and being here for the last 45 minutes, I am almost befuddled about what types of questions to ask. Maybe I will just direct it in one particular area, in which actually it probably surprised me a great deal. The testimony, I think it was yours, Mr. Salisbury, but it may have been some others, as well, suggests that portability is not the problem in the sense that there is a lack of portability, as I think many people might think.

Maybe you just might pursue that a little bit.

Mr. SALISBURY. The issue of portability is a question of will individuals as they change jobs end up with the ability to have a pension when they retire. The essence of Mr. Irish's comments, setting aside his proposal, the essence of the proposal is preservation of the dollars that have gone into these systems, such that when people retire, those dollars are still there, and what we have ended up developing, and this goes back to pre-1986 tax law, even more heavily than post-1986, is we have always had tax laws that give a tremendous tax advantage to taking a lump-sum distribution as compared to an annuity.

During the very high interest rate period of the 1980's, we ended up having that advantage accentuated, because one could take the lump sum, get very favorable tax treatment, and also invest the money at much higher rates of return than what was the implicit rate of return in the pension plan itself.

The result is the vast majority, probably 99.5 percent or more, defined contribution plans which are now growing, which as the chart in my testimony indicates as the prime plan in the eyes of individuals, exclusively, almost exclusively pass lump-sum distributions, whereas defined benefit pension plans, when they grew in the 1950's and 1960's, predominantly paid benefits only in annuity form.

The most recent report indicates almost half pay lump-sum distributions, when, given that alternative, between 85 and 95 percent of the employees choose to take the lump-sum distribution. If one looks at what happens to these lump-sum distributions, the most recent Census Bureau data was May 1988 data. It indicated 13 percent of the individuals receiving these lump-sum distributions chose to roll them over into another employer plan or an individual retirement account.

Thirty-four percent immediately spent the money, and the balance did some combination of spending and saving, it depends on your definition. Saving was considered—it was considered to be saving if you used it to pay down credit card debt. It was considered to be spending and consumption if you went and bought a car, for example.

So, you are ending up last year, by our estimates, as much as $14 billion in retirement lump-sum distributions that flowed out of the system, because people chose not to roll them over. If you put that in relatively simplistic terms, the current law provides any plan can automatically require the individual, if the benefit value is less than $3500, to pay it out.

With relatively young participation rates and low vesting periods, that means that an awful lot of people get these small distributions. They are almost universally taken out, tax paid on them and spent.

If you end up taking the minimum wage worker, carrying them out over a 40-year career and assuming they get four of those distributions and they always stay at the minimum wage, by the age of 65, that account, at an accumulation of 2 percent real rate of return, would produce an account balance equivalent to two and a quarter times final pay, which is a fairly significant lump of money, if you will, at that point, even though these amounts seem very insignificant when the person was changing jobs.

So, we end up with a system that I describe as a system where, if anything, far too much cash portability in the absence of preservation. Where it ends up showing up in the long term, in spite of the fact last year, employment-based pensions paid over $236 billion in benefits to retirees, 40 percent more than the total Social Security primary retirement benefits. I would note we end up with a situation now where we are seeing an increasing amount of money flowing out of the system in lump sums, which ends up in the long term, even the individual that takes that money, pays tax under 10-year forward averaging plus favorable capital gains treatment if they were over the age of 50 in 1968, and puts it in a personal savings account and gets long-term investment income off of it, the way we keep our national data, that ends up showing up as if they had saved a lifetime outside of the pension system.

The pension system gets no credit for that money, and that has amounted to tens of billions of dollars as well, so we end up with a system that appears to be actually doing less than it is in terms of incremental savings, but also doing far less than it could for the generations 10, 15, 20 years from now in production of retirement income because of an absence of preservation of those dollars.

Mr. HILER. Would you—I presume then it would be your belief that because the concept of deferred income and a pension benefit tries to establish both a long-term benefit for the employee, as well as a long-term savings pool for the economy at large, that the Government has not only a vested interest, but would have the right to say: If in fact you were going to get the decided tax benefit that comes with deferred income, then that amount of money will be locked up for a substantial period of time or there will be substantial tax penalties that would overcome everything but hitting the lottery pick.

Mr. SALISBURY. If the objective is retirement income, yes, and I would be the first to say if instead Congress decides the objective is simply savings, a proposal, for lack of a better example, like a family savings account, makes sense if the objective is purely savings.

If the objective is retirement income and the success or failure pension system is going to be judged on the delivery of retirement income, it is unfair to judge that system if basically the legal framework currently in place guarantees huge amounts of money will not end up being there at retirement.

You end up with the equivalent of Catch-22. The only comment I would make on the proposal before, which was to say you can't give a lump-sum distribution, or it goes to a Government clearinghouse or whatever, would simply to be if we were to carry that out and talk to him about this Government clearinghouse being the overseer of $2 trillion, $3 trillion of assets invested in the private economy, that leaves me to raise a whole series of secondary questions that I think would have to be very carefully explored, and nothing I have seen written on it, to my view, fully explores those economic types of issues, control issues.

Second, if our objective is companies deciding to have plans, I would suggest if that is the objective, particularly with small business, then preservation would far more readily be accomplished by a requirement that lump sums, if paid, be rolled over into a new employers plan or some third party whether an IRA—or this agency rather than saying to the company, you cannot provide a lump-sum distribution.

As for the small business particularly not being able to provide it to the third party fund does have significant long-term administrative costs for the very small firm. The large firm, I don't worry about as much, but a very small firm, that could be a problem.

Mr. HILER. Wouldn't for a small firm today; it would just seem that everything, the regulations, et cetera, all argues for them to establish some type of 401(k) plan and be done with it at that point, doesn't it?

Mr. SALISBURY. I would probably even step back ahead of that. If one is going to create a plan, then the answer to a very large company is yes. I think if we made a change in the law—had we made it in 1986, when we dropped tax rates very, very significantly, and then amended the law in 1987 and 1988 to significantly decrease what small employers could put in the plans, that basically from a tax perspective, it no longer makes particular sense for very small businesses that traditionally—based on the survey data, recent survey published in California, California companies—the number one reason the small employers have created plans was the tax advantage, at 15 percent and 28 percent rates.

The fact is the tax advantage is no longer very great for those small firms, particularly with restrictions. I think in the current tax rate environment, the likelihood of small businesses in any large numbers to go define contribution arrangements, whether they be SEP's or 40K's, is very, very unlikely.

If one is looking for an argument to raise tax rates significantly, I would suggest expanded pension coverage could be used very effectively for why we want higher margin tax rates.

Mr. HILER. I don't think I will use my campaign as a place to try that out. I yield back my time, Mr. Chairman.

Chairman LAFALCE. Thank you. Let's just try and cover some of these issues discreetly, and let's start out with the joint trusteeship issue. We have tried to get a variety of viewpoints on all issues here. I think it—at least the first three members would clearly have opposed and voted against the Visclosky.

Mr. Salisbury?

Mr. SALISBURY. In my individual capacity as drafted, I would have voted no, but I simply wanted to stress——

Chairman LAFALCE. I understand, you don't have to expand upon that.

Mr. SCHOTLAND. I clearly would vote no on the draft proposal.

Chairman LAFALCE. I just asked that so I could have some defense with many of my friends. While I understand the problem, I thought, too, it was an inappropriate approach, and I was rather annoyed that I had to vote yes or no on such an inartful approach to a very real problem.

We are the Small Business Committee, and therefore, we have special responsibility for small businesses, pension plans that small businesses have, or the fact that small businesses don't have pension plans. We have to take that into consideration.

One thing we could do, if we had Son of Visclosky, whatever it might be, is to simply have a small business exemption. I would like your thoughts on that, whether it is 50 employees, 100 employees, 25 employees, or some exemption not based upon employees, based upon some other standard, and then deal with it, not with mandated joint trustees, but some other way.

On the other hand, as a Member of Congress, I represent Rochester and Niagara Falls. In Rochester, I have Eastman Kodak, a rather large employer, probably about 60,000 nationwide, single employer, nonunionized. Maybe unionized—maybe it should have been, but it is not, and so one of the issues there is would we in effect be requiring either under a mandated joint trustee arrangement or a participation arrangement, Professor Schotland, some type of employer-sponsored employee election of representative for participation, is this something the Federal Government should be doing, or should we be permitting what we have done, employees to associate and let employees who have opted to associate with others in a union then negotiate over the bargaining table regarding what type of representation or participation they should have, even in a single-employer plant?

So, let's take the small business aspect first, and then let's take the larger business aspect. First, the small business. Who would like to address it? Ms. Altman? Mr. Irish?

Ms. ALTMAN. My feeling is that it is hard to make a principled exception for small business. There are a lot of practical and operational reasons you——

Chairman LAFALCE. Chairman of Small Business may take it any way he can get it.

Ms. ALTMAN. I guess your premise is the Visclosky amendment passes in some form, and the question is, should small business——

Chairman LAFALCE. I am not posing that, but if this be the case, some variation of it.

Ms. ALTMAN. The argument I guess for a small business exception would be first of all, in some ways, operational, although you can make arguments both ways. It is obviously easier for a unionized company to figure out how you are going to have worker representation, although in a small business, you have fewer employees.

The other is impact on coverage and inflexible requirements and that sort of thing. I have trouble with the overarching concept of the Visclosky amendment, but within that, it is hard for me to come up with a principled argument in favor of carving out an exception for small business.

Mr. IRISH. May I try?

Chairman LAFALCE. Sure.

Mr. IRISH. I think one could clearly carve out one-person plans and plans with only highly compensated employees in them.

I think in each of those cases, we are dealing with a situation where we shouldn't really worry about how the plans are administered, for the people who have 100 percent at stake are in charge of the plan.

Chairman LaFalce. That is easy. I have my own small business, and I have hired employees, and I want to have a plan for them, but by God, I don't want to encourage them to rebel against me and form their team. It is us, and all of a sudden, it is them against me if we go to this pension plan. Should we——

Mr. Irish. I think that in small companies, joint boards become cumbersome, so——

Chairman LaFalce. This is not my perspective.

Mr. Irish. I think this problem goes away if we repeal section 403(c)(3) and go to independent managers to manage the money, to manage the claims, and to vote employer stock when that is not passed through. All of those services are out there on an economically feasible basis.

I think what we ought to want is independence. So, beyond the two exceptions, which I think are easy, I don't think we need more exceptions.

Chairman LaFalce. Suppose, I am an employee, and I say now, look it, you know, you are giving us the pension plan, we didn't get the wage increase this year. That is just a deferred form of compensation, and you know, you go to the country club with this guy and you are going to hire him, but look it, from what I have heard, he is no good.

All right, it is your decision, but shouldn't I have a little bit of a voice in it? Sort of like Professor Schotland was saying. This is assuming the repeal. There is nothing necessarily incompatible between repealing section 403(c)(3) and still requiring some type of employee participation. You could pursue both approaches, it seems to me.

Mr. Salisbury. I go further, Congressman. The concept that there is anyone out there that is totally and completely independent and not subject to some of the potential situations that were mentioned in the testimony is a little hard for me to grasp.

The individuals, for example, who are the for-hire independent fiduciaries of the firm that Mr. Schotland is on the board of have many involvements. Their employer has many involvements with many other organizations. The concept that they somehow would be puritanical just because the rules say they are puritanical, or more objective and third-party, I have some difficulty with this conceptually, if you will, independent line criticism of the system.

Chairman LaFalce. What is your comment on Mr. Irish's proposal to repeal section 403(c)(3)?

Mr. Salisbury. That is what I am saying. The concept that somehow you solve all the world's problems by having everything turned over to a third party, independent fiduciaries, and then you need not worry about any of this is——

Chairman LaFalce. Suppose it wouldn't solve all the problems—let me finish my question, please. Would it still be a good, even though a limited good, Mr. Salisbury?

Mr. Salisbury. My immediate reaction, no.

Mr. Schotland. Agreed.

Mr. Salisbury. But I have not studied it.

Chairman LAFALCE. Professor Schotland, why do you think it wouldn't even be a limited good, to repeal section 403(c)(3)? In all candor, I was trying to see some type of a blending of Mr. Irish's approach and your approach, but——

Mr. SCHOTLAND. Here you are trying to bring people together.

Chairman LAFALCE. That is right. You are saying, nice thought, but no buy. Why are you not buying?

Mr. SCHOTLAND. To the extent Lee Irish is right, and to some extent unquestionably he is, that there are inadequacies in professionalism or in the seriousness of attention given these matters, to reduce the obligations on somebody in corporate management to bring this the best attention and professionalism they can, seems to me counterproductive.

Chairman LAFALCE. Suppose we only take half of Mr. Irish's proposal and we repeal it with respect to claims adjudication, and say this has got to be on the outside?

Mr. SCHOTLAND. Off the top of my head, I am not sure, but that I am much, much less troubled with. That is a very interesting idea.

Chairman LAFALCE. OK. Then, maybe Mr. Irish, you would only want to go for half of Mr. Schotland's proposal.

Mr. SALISBURY. Mr. Chairman, could I momentarily mention a second point?

Chairman LAFALCE. Sure.

Mr. SALISBURY. Even full repeal does not solve the joint trusteeship set of issues, because someone has to select the independent fiduciary.

Chairman LAFALCE. We were going with the fellow at the country club.

Mr. SALISBURY. The essence is if you can't trust these people to run the plan, so you want to repeal this and get the independent fiduciary, can you trust them to select the independent fiduciary without employee involvement? So, I don't see that as the clear alternative to the other policy objective, if the other policy objective needs to be obtained. In terms of your specific question on small business——

Chairman LAFALCE. We could handle it pretty easily for a small business. We could, for example, give your employees, your 10 employees notice of the individuals you are considering and solicit their comments. If I had 60,000 employees, that might be a lot more difficult. So, I can more readily see how with small businesses, you could have employee participation in a rather informal manner.

I don't know how you would have employee participation with a large corporation in an informal manner. That is—you want to address that, Professor Schotland?

Mr. SCHOTLAND. Yes, sir. I think you are making the right distinctions, if I may put it that simply.

Chairman LAFALCE. First law of thought, distinguish, OK.

Mr. SCHOTLAND. Earlier—I seem to be full of surprises this morning. Earlier, Ms. Altman said she couldn't see a principled way to distinguish small business. That both surprises and puzzles me. I would have thought economies of scale have us say a company like Eastman Kodak is different from a company with 20 employees who can't afford to do that kind of thing.

From the point of view of obtaining outside experts, it seems clear to me there is an important, principal distinction between small business and a good reason to exempt them from all kinds of requirements, and, I like your idea of informal.

As you were talking, I was thinking of the requirement at the small business might just be sunshine. That is, let them announce when they are going to meet on the pension plan and anybody, if there are 20 employees who wants to come and sit and listen could come and sit.

I would also distinguish, as you are suggesting, between the unionized and nonunionized. I would even distinguish between the unionized where the retirees have some role in the union and those that are dropped.

Chairman LAFALCE. With respect to—I need a little data here. Mr. Salisbury, with respect to unionized employer situations, what percentage of them have representation or participation with respect to their pension plans?

Mr. SALISBURY. It is exclusively in the multi-employer universe, which represents about 2500 plans.

Chairman LAFALCE. So, even if you have the UAW or you have——

Mr. SALISBURY. For example, General Motors. General Motors has one of the Nation's largest pension plans. It is attributable to the salaried workers and a fully negotiated agreement with the United Auto Workers. It is in single trusteeship, meaning there is no employee representation.

Chairman LAFALCE. Has this been an issue in negotiations between big management?

Mr. IRISH. Walter Reuther said, as a matter of principle, that unions should not want involvement in the administration of pension plans. He thought companies would do a better job and that workers got into trouble when they started running pension funds.

Mr. SCHOTLAND. Walter Reuther is long gone. The suggestion isn't whether the workers should run it, the suggestion is they should know what is happening.

Chairman LAFALCE. That depends on who is suggesting.

Mr. SCHOTLAND. Even if the unionized—if you leave it to bargaining, there are all kinds of issues that have higher priority than this one. If you say, let them bargain over it, what you are really saying is, leave it alone.

Chairman LAFALCE. I don't know. Congress is considering a good many issues where it seems to me they have not been of enough priority to even have taken up time at the bargaining table. If they are that important, why haven't they been widespread—why haven't they been subjects of negotiations on a widespread basis?

Maybe they have been the subject of negotiations in an isolated instance. I am unaware of maybe in some instances that are not so isolated that I should be aware of. The same with family leave—I happen to favor family leave, at least the bill introduced 4 years ago, not the bill that came before Congress last time, because that was so much greater than the bill 4 years ago; it extended it to spousal leave, and leave for sick parents.

To my knowledge, only one country in the world provides that, Sweden. Only two States in the Union, and they just both adopted it in the last year or two. We have to focus in and come up with discreet solutions to discreet real problems, rather than spinning our wheels.

Mr. **Schotland**. Mr. Chairman, UAW is certainly one of our greatest unions.

Chairman **LaFalce**. Absolutely.

Mr. **Schotland**. They didn't bargain well enough, and I don't fault them, to have avoided the Studebaker collapse. There are points at which government requirements do have to come in to keep the playing field working, so I think the fact that it may not get high enough—after all, you are bargaining—you are the labor representative, which are you going to put higher more benefits, more pay or more leave, or some participation in the management? I think it is clear every time, you are going to put this among the bottom of the list.

Chairman **LaFalce**. How do we do this? It is relatively easy if we mandate it for single employers and you have a unionized situation, OK, union comes up and union says here is what we want as either representatives or as participants, or whatever, but how do you do it within a nonunion context in a large corporation, or mixed situation, without having Government come in and tilt the scales toward one side in this collective bargaining process?

Mr. Grubbs.

Mr. **Grubbs**. On the carve-out question, how can we have a carve-out, I would carve out those groups where the management is in professional hands. I would carve out where there is a bank trustee with bank management or bank trustee with registered investment advisors as managers, group annuities with insurance companies or all assets in no-load mutual funds.

Chairman **LaFalce**. So, let me just flush this out a little bit, maybe. So, we repeal section 403(c)(3) exclusively with respect to adjudication of claims, and then——

Mr. **Grubbs**. With respect——

Chairman **LaFalce**. With respect to the management, if they opt to take advantage of the section 403(c)(3) exemption and have management trustees, then we would permit, under those circumstances, some type of employee, either representation or participation.

Mr. Irish is nodding in the affirmative, as if maybe we have got some—how about Professor Schotland? How does that sound?

Mr. **Schotland**. When we have got Son of Visclosky before us—for example, I know Citicorp, I believe, still has employees.

Chairman **LaFalce**. My counsel is still worried about that bum banker.

Mr. **Schotland**. I take it—I wasn't yet getting to Mr. Grubbs' suggestion by carving out all plans managed by somebody that hasn't been convicted. Citicorp has had employees participate in a committee to decide how to vote the proxies of the shares that are held in the pension plan.

I am sure there are other companies, because we have got a lot of absolutely marvelous single-employer plans: GE, GM.

Chairman **LaFalce**. This looks like a data question. Mr. Salisbury, do we have any data as to the type of companies, such as Citicorp, who have come up with proposals such as that?

Mr. Salisbury. Not any general data. It is the exception.

Mr. Schotland. We have had a few small companies, I can't even think of the names at the moment, which have put people on the boards. I have heard of one or two or three of those, but if we get to Son of Visclosky, instead of banging horns over a clearly overbroad proposal, then we can sit down and say, look, what is the right to do this? Whether there is no union or some union or nonunion?

Chairman LaFalce. Should we distinguish between defined contribution and defined benefit plans?

Mr. Schotland. Absolutely.

Chairman LaFalce. Everybody agree?

Mr. Irish. It is hard to imagine why employees should play a role in the investment of assets as to which they take none of the risk.

Chairman LaFalce. But that was Visclosky, wasn't it?

Mr. Irish. That was Visclosky.

Chairman LaFalce. Are your proposals with respect to defined contributions or defined benefit?

Mr. Schotland. Both.

Chairman LaFalce. When I said, should we distinguish, you nodded your head.

Mr. Schotland. I think in defined contribution, I would give them a larger role.

Chairman LaFalce. You want participation in both, but a larger contribution and a lesser in the defined benefits?

Mr. Schotland. Yes; I don't want to jeopardize employer control of assets the employer has to stand behind.

Chairman LaFalce. I see.

Mr. Schotland. But I don't see that allowing somebody to sit there and allowing someone to sit there and sit there and watch, and allowing whether it was just the country club, I don't think that jeopardizes management, I think it improves it.

Chairman LaFalce. With your conclusion, let's go to the IRS audit. I get the impression that OMB made a judgment that a certain amount of money had to be raised, and this was one way of raising it, and the Treasury and IRS had to figure out how to raise money and they said, OK, this is one good way to achieve it, and we could make a reasonable argument behind this type of enforcement activity. Anybody care to comment on that suspicion? Come on, Mr. Grubbs.

Mr. Grubbs. IRS is often motivated to raise taxes; nevertheless, they do have an obligation to find abuses, and there are abuses out there. The real question is, are they properly sorting out abuse situations from nonabuse situations? My answer to that is they are going about it partly right and partly wrong.

Chairman LaFalce. Isn't there a better way to do it than the way they have done it? I mean, wouldn't it be better, say, to just look at the amount of deductions per person and target it based upon that criteria?

Mr. Grubbs. Deductions per person? In a defined benefit plan, the amount that is needed to soundly fund the plan varies greatly with the ages of the people, with the salaries, turnover rates and a wide variety of factors, so that any rule of thumb of that sort, as a practical matter, just wouldn't work.

Chairman **LaFalce**. All right; I know there is a reluctance to have Congress rush in every time there is a problem, and I share that, OK. But if we were back at the beginning, not talking about remedial legislation, might it not have been better to have some pegged interest rate that could be used rather than a reasonable interest rate, and so you could tie it to Treasury bills?

You could tie it to 30-year bonds or Treasury—I don't know. So that you would at least not allow manipulation of that assumption? Anybody care to comment on that?

Mr. **Irish**. One of the things that has puzzled taxpayers in the small-plan audit problem, as I mentioned on page 32 of the statement, the IRS has blessed 5 to 6 percent interest rates for target benefit plans in a formal revenue ruling, and it puzzles them why that isn't deemed an equally good rate in other situations.

I think Don has explained why in the real world it hasn't been a realistic rate. I think the general proposition is very well taken, but I think the IRS has been quite remiss in not getting out good public guidance before this problem became an enormous one.

Chairman **LaFalce**. What if we suggested to IRS or require that IRS annually promulgate the interest rates which had to be used? Would that be so terrible?

Mr. **Salisbury**. It would be consistent with the annuity rates that are published by the Pension Benefit Guaranty Corporation.

Chairman **LaFalce**. Say this is the rate you have to use.

Mr. **Salisbury**. Or this is the minimum interest rate you can use.

Chairman **LaFalce**. The problem is they might go with too high of a minimum, I suppose. They might come up with 8 or 9 percent as your minimum.

Mr. **Salisbury**. To put it in the context of the entire small plan issue, I think the principal reaction that is coming forth——

Chairman **LaFalce**. It seems to me that your small plan wants predictability, wants certainty, and would sacrifice an added deduction if you just had certainty.

Mr. **Salisbury**. I agree.

Chairman **LaFalce**. OK. That takes care of the interest rate. What about the retirement age? Mr. Grubbs, IRS seems especially egregious on that score, don't they, when the fact of the matter is that the majority of the retirees are retiring at an earlier age than is permitted by the IRS audits?

Mr. **Grubbs**. Sixty-two would certainly be a more reasonable cutoff point. There are certain situations, certain industries, certain companies, where there might be justification for an earlier age, so absolute rules are inappropriate.

Chairman **LaFalce**. But if they use 65 as an absolute, that would be inappropriate, wouldn't it?

Mr. **Grubbs**. I would think anybody 62 or above should be acceptable, since 62, after all, is the most common age.

Chairman **LaFalce**. What is IRS using right now?

Mr. **Grubbs**. 65 or higher.

Mr. **Irish**. You would offer it as a safe harbor, not as an absolute rule?

Mr. **Grubbs**. I would provide, as now, as under the current rule, you can come in and demonstrate there are reasons why you are going to use something earlier.

Chairman **LaFalce**. All right; another thing that disturbs me, because there is this degree of uncertainty, it is one thing to engage in disallowances or what have you. It is another thing to impose a penalty. What can we do about the IRS' tendency to impose penalties in these situations?

Mr. **Irish**. I am afraid, Mr. Chairman, that Congress has put them in the Code, and it is very difficult for the IRS, except in cases where they can be waived for good cause, not to impose penalties that Congress has put in there when you overstate——

Chairman **LaFalce**. It is a mandatory penalty now?

Mr. **Grubbs**. Right.

Chairman **LaFalce**. Bad section; 51 percent of me voted yes, 49 percent voted no. That was one of the 49 percenters.

Ms. Altman?

Ms. **Altman**. It may help to encourage settlement in egregious causes.

Chairman **LaFalce**. Yes; but it would seem to me, if the penalty were discretionary, it would have the same effect, then you avoid this bad effect, it seems to me. We could go on endlessly. What about just putting an upper limit on the amount of the contribution in your defined benefit plan?

Mr. **Grubbs**. That limit might be less than is needed to soundly fund the benefits that are promised under the plan if one did it in dollar terms.

Chairman **LaFalce**. You would have to reduce the benefits then, too, but in other words, you would only permit the utilization of the plan for a lesser benefit in order to keep the whole program under control.

Mr. **Grubbs**. We currently have in section 415 limits on the amounts of benefits that Congress has determined. If these are appropriate——

Chairman **LaFalce**. What is that limit right now?

Mr. **Grubbs**. It is $90,000, but it gets indexed, year by year.

Chairman **LaFalce**. That is a pretty high benefit. Professor Schotland, you don't think so?

Mr. **Schotland**. Yes, sir, I was just thinking about Roger Smith. If you lose 10 percent market share, you get a better pension. Think of what they will do for somebody that takes them down 20 percent.

Chairman **LaFalce**. How would you handle that? Would you lower the 90 percent? You would certainly eliminate the indexation, wouldn't you?

Mr. **Schotland**. No, sir, I would defer to the rest of the panel. You have got unusual expertise and I am just ordinary on this.

Mr. **Grubbs**. If we determine what is an acceptable level of pension, whatever it is, we want contributions that are appropriate. That level of contribution is going to vary greatly depending upon the ages of the people and salary levels and other characteristics.

Chairman **LaFalce**. I am going to the fundamental threshold question, whether we should be permitting tax expenditures to be used for benefits of that high amount, $90,000.

Mr. **Salisbury**. I would only add the comment that the amount of pension now payable to long-service Members of Congress is right around that figure, and there are a number of individuals who are retired Congressmen whose annual pensions far exceed that number.

Chairman **LaFalce**. How does that add or subtract from the point I was making, Mr. Salisbury?

Mr. **Salisbury**. Simply, the appropriateness issue vis-a-vis amounts of pensions that can be provided and paid for with taxpayer dollars, purely.

Mr. **Schotland**. For once, I have got to disagree with Mr. Salisbury. I have written what may be the only treatment of congressional pensions, and they are extraordinarily rich, but they have also been changed as of several years ago. Newer members are not getting an extraordinary pension, and I think that problem has become history.

Chairman **LaFalce**. What was that?

Mr. **Schotland**. You are not going to take it away from senior members. The question is, phase it in as they come in, and they have done that, and I think they have done the responsible thing.

Chairman **LaFalce**. That sounds to me like the plumber and the plumber's assistant argument, Mr. Salisbury. Yes?

Mr. **Irish**. A couple of things that need to be borne in mind as you wrestle with these issues is that cutting down the amount of permissible accruals for the highly paid tends to decrease overall interest in having pension plans or having them cover a lot of people.

We don't know quite what that relationship is, but generally as you bring down the 415 limits on what may be built up with tax advantage, we can expect less coverage or less good benefits.

Chairman **LaFalce**. Mr. Rostenkowski has suggested if you don't like his plan, come up with some alternatives. Might the reduction in the $90,000 be something that could be considered?

Mr. **Irish**. I will not be surprised to see it. The second thing is that setting interest rates and ages that are relatively high particularly interest rates at 8 or 9 percent, will tend to make it hard to fund larger plans at rates which are really quite appropriate.

I understand the proposal is that we always allow special cases to be proven, but once you have got safe harbor rates out there, it becomes much more difficult to demonstrate a need to use lower interest rates, and they are often quite appropriate in larger funds.

Chairman **LaFalce**. Miss Altman, you had the first word, I will give you the last word.

Ms. **Altman**. Thank you; actually, Lee Irish made one of the points I was going to make which concerns the 415 limits. The engine that drives the private pension system is the desire for higher-paid employees to have their own pension protection. We require low- and moderate-employees to be brought along.

To the extent you make those pensions less attractive for the high-paid employees so that they can do as well by saving on their own, you reduce coverage. On the general point about the IRS audit and trying to have very fixed kinds of safe harbors, the problem again is the difference between small plans and large plans.

When you have got 60,000 employees it is appropriate to look at average trends—average retirement age, average mortality, and so forth. When you are talking about three or four people, it really is incumbent on the Government and the plan to look at the actual experience. If you have a person who is going to retire at a particular age safe harbor, inconsistent with the facts, that allow more funding than should be permitted may be inappropriate.

Chairman LaFalce. That was to be the last word, except I just thought of something. Mr. Irish, Mr. Grubbs, and Mr. Salisbury had a problem with the original Grubbs' proposal, and the NEST proposal, and it was more a macro economic one, as I understand it—what could you do with this trillion-dollar nest egg that is sitting there. Who is going to be holding it and who is going to be doing what with it for good or for ill. What are the economic effects. Have you thought that through?

Mr. Irish. I think it is a very important issue and needs detailed thought. My own suggestion is that the money in the National Employee Savings Trust [NEST] be managed by private hands, not by the Government, and that the rules for selecting the private managers be as free of any kind of particular bias toward industries or investment theories as possible so that, in fact, the private sector manages pensions that have been built up in the private sector, but that we keep the money in the pension sector and not let it spill out through lump-sum distributions.

Chairman LaFalce. Mr. Grubbs?

Mr. Grubbs. I concur; we have two alternative models out there. First, PBGC is investing plan assets, and they have selected private trustees to invest those in private securities. Second, we have the——

Chairman LaFalce. Do they or are there any really large pension plans where they divide up the moneys and put portions of the moneys under different management, Professor Schotland?

Mr. Schotland. Yes, sir, back before the AT&T break up, I think they had around 100 or more managers. Here I think the answer is simple. I would index. You can index both the equity side and fixed-income side, you can index internationally and then the only question becomes asset allocation, and even there you can go to systems where there is virtually no discretion once you pick the system.

So I don't see the—this isn't as if we started investing social security funds, given their amount, in private sector securities.

Mr. Grubbs. I concur; that is the second model that we already have, the Federal Employees Thrift System where the equity fund is invested basically in the S&P 500. It is an indexed fund.

Chairman LaFalce. OK.

Mr. Schotland. We can require them, though, sir, not to limit it to the S&P 500, go to what we call the Russel 2,000 so we get some more smaller companies. You should make sure that is done if we do this.

Chairman LaFalce. That comment in and of itself made this a worthy hearing, OK?

Mr. Salisbury. Or if you want even more, go to the Wilshire 5,000.

Mr. Schotland. I accept the amendment.

Chairman LaFalce. Sounds good to me. Thank you very much.

[Whereupon, at 12:13 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

Opening Statement by Chairman John J. LaFalce
Committee on Small Business

June 5, 1990

The United States has developed a three-pronged approach for meeting the financial needs of our retirees: social security, individual savings and private pensions. I think that this approach makes sense. But I believe that each of these three elements must be strong and generally available in order to assure an effective retirement system.

Therefore, I am deeply concerned that utilization of the nation's private pension system is decreasing. Formation of new plans has dropped significantly, while the termination of existing plans is increasing. These are disquieting trends.

Of equal concern is the fact that small businesses have lagged considerably behind other segments of the economy with regard to providing pension plans for their employees. In 1986 fully 91% of employees in firms with 100 or more employees were covered, while only 43% of those with fewer than 100 employees participated in a pension plan. The lack of coverage for tens of millions of employees does not bode well for them individually or for the nation as a whole.

It is appropriate, therefore, that Congress review the incentives -- and disincentives -- that make up the present system. We should do what we can to encourage employers to offer pensions, and we should eliminate unnecessary roadblocks put in the way of the establishment or continuation of plans. Most importantly, we should be very careful about making further changes in a system which is already overly complex unless such changes are absolutely necessary. With this approach we may be able to find ways to improve coverage and thus help ensure financial security for our workforce.

Two subjects we asked our panel to address are specific issues that have arisen which are of particular concern to small employers. One is the proposal that we require joint trusteeship for workers and management for overseeing single-employer pension plans, known as the Visclosky Amendment. The other is an IRS program which specifically targets small defined benefit plans for audits if they meet certain criteria. I will be interested in hearing our witnesses views on the wisdom and fairness of both of these matters.

In addition, we will be looking to the panel to provide us with their ideas on simplification of the pension system so more small employers can offer pensions; on proposals to increase the portability of pension benefits so increasingly mobile workers can participate in greater numbers; on regulation of the pension program; and on questions about the use of pension funds for mergers and acquisitions.

I look forward to hearing the views of our panel on these and related subjects, and I am hopeful that we will come away with some practical suggestions on how to make our generally successful pension system even more so.

Statement of the Honorable Joseph M. McDade
Vice Chairman
Committee on Small Business
U.S. House of Representatives
June 5, 1990

Mr. Chairman, I appreciate your calling this hearing today to discuss an issue that is crucial to the peace of mind and future financial stability of much of this nation's workforce--the availability of employee-sponsored pension plans in the small business community.

Employee sponsored pension plans are an important component of retirement income for over one-quarter of the nation's workers. Additionally, over half of all workers are employed by companies offering some form of a pension program. However, only 16 percent of employees in firms with 24 or less workers have access to a pension plan through their employer.

The main reason for this shortfall in the small business community appears to be the high costs associated with a complex and changing system of administration. Small businesses simply cannot afford to pay the enormous consulting fees that are required to unravel the constantly evolving rules and regulations governing pension plans, despite the tax benefits that come to both employees and employers. Perhaps the solution to more affordable pension programs is to make the current system less complicated and reduce the number and frequency of changes to federal regulations, which only add to the overall cost of offering a pension plan.

I look forward today to the testimony of these distinguished witnesses to help us better understand this issue and to offer solutions to one of the main challenges facing small businesses owners across America.

STATEMENT OF NANCY J. ALTMAN
BEFORE THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

June 5, 1990

Chairman LaFalce and Members of the Committee on Small Business:

Thank you for inviting me to testify before your Committee. My views about retirement income are the product of my private sector experience, where, as an associate at Covington & Burling, I advised clients on pension matters; my public sector experience, where I served as an assistant to Senator John C. Danforth (R-Mo.) and to Dr. Alan Greenspan, in his capacity as Chairman of the National Commission on Social Security Reform; my university experience, where I taught courses on retirement income at the Harvard Law School; and my current experience, where I serve as Vice Chairman of the U.S. Department of Labor's ERISA Advisory Council and as a member of the Board of Directors of the National Academy of Social Insurance. The views I express are solely my own.

The Chairman of this Committee has expressed concern regarding the large number of workers who lack private pension coverage. As he has pointed out, a disproportionate number of those workers are employed by small business. His concern is well placed.

Pension coverage is a prerequisite to receipt of pension benefits. The widespread lack of coverage raises serious questions concerning the adequacy and equity of the retirement income system.

Today only about one-quarter of all retirees receive private pension benefits. Social Security replaces pre-retirement wages at rates that are too low to maintain a worker's pre-retirement income in all cases except those at the very lowest end of the income scale. Retirees who have no private pension but rely solely on Social Security have average incomes only half the level of those who receive private pensions. Moreover, because employer-sponsored pension plans are tax-favored, workers without private pension entitlement indirectly support, through increased taxes, similarly situated workers who qualify for such tax-favored savings.

The range and content of the issues which are the subject of today's hearing illustrate the challenge before this Committee and Congress in expanding private pension coverage. At least in part out of a desire to expand that coverage, this Committee has asked those testifying at today's hearing to address the question of simplification. At the same time, the other subjects of today's hearing reveal the multiple and conflicting goals which make both simplification and expanded coverage difficult to achieve.

The subject of portability spotlights concerns about the adequacy and fairness of the pension system as it relates to mobile workers. Questions about the desirability of joint trusteeships, about the general soundness and integrity of the system, and about the decision to target enforcement activity on small business, arise from the legitimate regulatory concerns that the interests of the beneficiaries of pension trusts and of the federal government be protected. To the extent these are realistic concerns in need of solution, they are likely to result in the imposition of increased burdens on employers maintaining plans.

The Chairman has expressed his attitude that any new pension legislation should expand coverage. I respectfully disagree. While expansion of coverage is an important goal, I do not believe it should override all other goals. In this statement, I will first attempt to address the specific topics raised by the Committee both in terms of the goals seeking to be furthered and in terms of the likely impact on the maintenance of pension plans by employers, particularlv small employers. In concluding, I will offer some thoughts about how the various conflicting goals underlying these issues should be viewed in light of the objective of expanded coverage.

Simplification

The goal of simplification is admirable and, in the abstract, noncontroversial. Nevertheless, it should be recognized that some degree of complexity is inherent in the present system.

The choice to have a hybrid system of retirement income, with reliance on voluntary employer-sponsored pensions as well as a public program of social insurance, is a good one. The current system offers a variety of strengths which would be missing in a unitary system. A hybrid system provides flexibility in structuring benefits, important in a complicated economy but difficult to attain under a nationwide, universal program. Also, it more easily results in diversification of control over vast sums of accumulated assets.

At the same time, reliance on a voluntary private pension system necessitates some complexity, which would not be present in a nationwide, uniform system. The complexity results from a variety of factors. First, even if the government were not relying on private pensions as part of our overall retirement income policy, it would nevertheless have some unavoidable regulatory responsibilities as long as employer-provided pension plans existed. Thus, the government would be called upon to resolve disputes among the parties. Moreover, as long as there were a federal income tax, the government would have to determine the tax consequences of pension arrangements.

In addition to this relatively straightforward governmental role, the reliance on private pension arrangements for a portion of the nation's retirement income support necessarily results in other complexities. Employers have a variety of motivations for establishing and maintaining private pensions for employees. While some of the motives are consistent with a national retirement income policy, some are not.

For example, in the absence of regulations, employers are likely to be concerned primarily with structuring their plans to discourage resignations by those employees whom they perceive to be indispensable and to reward those whom they perceive to be loyal. Moreover, younger workers may not appreciate the value of retirement savings, and employers will be indifferent to their coverage. In contrast, the government must be concerned about the retirement security of every person, including those who change jobs frequently, those who leave to work for competitors, intermittent workers, young workers and nonwage-earning spouses.

To the extent employer and government interests diverge, the government must seek to channel the employers' actions toward the broader societal purposes. This channelling can be done in two ways: through the imposition of mandatory regulatory requirements and through tax or other incentives. Imposing regulations on voluntary employer-sponsored pensions is, in many ways, similar to the regulation of other terms and conditions of employment. However, pension regulation differs from these other regulatory schemes in important ways.

Unlike most other regulated terms of employment, deferred compensation is dispensable. As a consequence, short of mandatory pensions, it is hard to imagine how effective labor regulation of pension plans could occur without the inducement of favorable tax treatment or some other governmental incentive. The decision to provide favorable tax treatment to certain forms of deferred compensation accords policymakers a second, independent justification for increased regulation of private pensions. Preferred tax treatment is usually reserved for transactions which serve a public purpose. For these related reasons, the government has developed complicated tax and labor rules, which by necessity have resulted in some overlap in administrative responsibility.

Moreover, because the private pension component of the retirement income system is voluntary and employers can choose not to participate if requirements become too burdensome, the government must carefully balance the needs and interests of employers, employees, and the public, including the cost to the Treasury, in structuring its rules. In the effort to achieve equity among the parties, many of these rules are quite complicated. Similarly, in attempting to meet the desire of employers to tailor retirement income arrangements to the particular needs of their employees, the government has developed rules responsive to a variety of contexts, as a result of the diversity of the economy. This further adds to the complexity.

As a consequence of all these factors, some degree of complexity is inevitable, given the nature of this system. Nevertheless, as with any complicated statute which has developed over time, opportunities do exist for simplification. Unnecessary duplication of requirements exists -- for example, involving the top heavy rules, minimum vesting standards and integration rules -- with marginal if any increase in the furtherance of public goals. Moreover, there are inconsistencies with respect to different pension arrangements -- for example, with regard to distributions of benefits -- which contribute to complexity without adding to the goals of adequacy, equity or security. These areas of duplication and inconsistency should be corrected.

A number of groups, in and out of government, are exploring specific simplification proposals, and they should be encouraged. Nevertheless, there is a limit to what rationalization and neutral simplification of existing rules can achieve. As I have stated above, much of the complexity of the rules are a product of attempts to balance greater worker protection against undue cost and burden on employers. These rules can only be made simpler by pushing the balance in one direction or the other. Much of what is cloaked in the cover of simplification really involves a substantive agenda. Proposals of this nature are likely to generate substantial controversy. It would be particularly ironic if proposed changes intended to simplify the area exacerbated a problem I consider worse than complexity.

What I believe has been much more detrimental to the health of the pension system than complexity or even the content of the rules is the frequency with which the rules have been changed. Prior to the enactment of ERISA, Congress passed very few statutes regulating private pensions. Since 1974, the year ERISA was enacted, however, legislation has been enacted in 1975, 1976, 1978, 1980, 1981, 1982, 1984, 1985, 1986, 1987, 1988, and 1989. There have been only three years between 1974 and 1989 when private pension changes were not legislated. In two of those latter years, Social Security was amended, so that even then plan sponsors had to take cognizance of changes in Washington.

The rapidity of the changes has resulted not only in increased complexity and cost for compliance but, more importantly, prolonged uncertainty. It is important to differentiate between complexity and uncertainty. It is uncertainty that generates compliance costs. Complexity is not a serious problem when the audience is experts, as long as the need for expert advice is not ongoing and expensive, shifting monies away from benefits, and as long as the concept behind the rules is clear so that participants can understand them in general terms.

The complexity and frequency of changes can be blamed in part for the termination of existing plans and the slowdown in the creation of new plans. Nevertheless, it is not clear that with greater simplicity and stability, even with simpler and more flexible simplified employee plans, many employers, especially small employers, would be induced to form new plans. Much of the complexity and cost can be avoided today if employers are willing to forego some of the options the current rules permit, like integration and limitation of coverage to less than the entire workforce.

Notwithstanding its unclear impact on expanded coverage, simplification is an important goal nonetheless. To the extent it can reduce administrative costs, thus freeing up funds for improved benefits, and can reduce intentional or unintentional noncompliance, simplification is important to pursue independent of its effect on encouraging increased coverage.

Portability

Like simplification, portability is an admirable goal. A fully portable pension system would be more equitable, bringing the benefits of mobile workers more in line with those of long-term workers, and more adequate, since accrued benefits would be preserved until retirement.

The part of our retirement income system which contains the most portable benefits is, of course, Social Security. Social Security benefits are based on the entire earnings record of workers, irrespective of the frequency with which they change jobs. Benefits of workers who change jobs many times are identical to workers who remain with one employer, assuming all the employments are covered by Social Security. Moreover, under Social Security, beneficiaries may not claim benefits until an insurable event, such as retirement, disability or death, has occurred. Benefits or contributions paid cannot be drawn down simply because a worker changes jobs.

Unfortunately, it is unrealistic to expect that private pensions can be made as portable as Social Security. The problem is that, unlike Social Security which is a single, universal, mandatory system, private pensions are a patchwork of different plan designs and different trusts.

In considering the portability of private pensions, it is useful to discuss separately the components of portability highlighted above. One aspect involves the preservation of benefits until retirement. The concept is that workers should be required to retain their accrued benefits until retirement. This could be accomplished either by keeping the benefits in the former employer's pension trust or by rolling them over into the new employer's trust, an individual retirement account or some newly created government clearinghouse.

While I agree with the goals of preservation, there are complexities which are not found with respect to Social Security. The benefit may not be worth the administrative cost of maintaining very small accruals. Moreover, in the case of a defined benefit plan, the benefits will lose value if they are frozen in a plan. A rollover may be necessary. However, this approach might necessitate increased liquidity of plans. If a central clearinghouse were to be created, new administrative costs would be incurred. Moreover, serious issues would be generated regarding the concentration of those assets in a single set of hands, particularly those of the government.

If it has any impact at all, preservation reforms would be likely to decrease pension coverage. Under current law, employers and employees have the option to preserve accrued pension benefits until retirement. Requiring that benefits be preserved until retirement is likely to be unpopular with many workers, especially when the funds are the product of their own contributions. Changing the law to mandate that benefits be preserved will simply make the system somewhat more complicated and less flexible. An approach which might accomplish some of the goals of preservation without a straight mandate would be to provide greater tax incentives to preserve benefits until retirement and greater penalties for early withdrawals. This approach too, though, is likely to be controversial.

The more conceptually difficult aspect of private pension portability, and I believe the more important aspect, involves the loss of real benefit levels as the result of employment for a number of employers who each have defined benefit plans where the benefits are based on final pay. Even if benefits are vested, they are worth relatively little under a defined benefit final pay plan, if the benefits are accrued early in one's working life. That is, in the case of an employer who has a defined benefit plan, where benefits are based on the worker's final pay, a worker who leaves at age 35, and retires at age 65, has benefits for those early years based on earnings that occurred thirty years before, unindexed for inflation, at a time of, presumably, relatively low earnings in that worker's career. Even if the actuarial value of those benefits are rolled over into another employer's plan or an individual retirement account, the benefits will not be of great value. This is in sharp contrast to Social Security, where early earnings are indexed and, therefore, remain current in value.

Making these early accruals under private plans fully portable for mobile workers is extremely expensive. In essence, it would require bringing the value of the benefits of nonmobile workers to the same level, or close to the same level, as long-term employees.

Employers could be required to index these early earnings and base benefits on the indexed amount. Alternatively, employers could be required to have combined defined contribution plans and defined benefit plans. Young mobile workers could then receive the benefit of the defined contribution part of the plan; older, long-term workers could receive the advantage of the defined benefit component. While both of these approaches would solve the problem of more adequate benefits for mobile workers, each would be very expensive to implement. They would both run counter to the goal of encouraging additional plan formations.

Notwithstanding the possible adverse impact on coverage, I believe policymakers should continue to investigate whether solutions of moderate cost exist which could increase the value of the benefits mobile workers earn under defined benefit plans. It may be that a compromise solution might be found which reduces, although does not eliminate, the discrepancy between mobile and long-term workers.

Abuse of the Pension System and the IRS Defined Benefit Plan Examination Program

There is no evidence that the private pension system is in a crisis, and certainly not one analogous in scope to the savings and loan situation, as the Chairman asked in his letter of invitation to testify. The analogy was first made by the Inspector General of the U.S. Department of Labor in his semiannual report to Congress for the period October 1, 1988 to March 31, 1989.

The claim appears to be a mere assertion without a strong factual background. In support of the claim, the Inspector General has referred to a study of 276 plan audits. However, he has not specified the kinds of violations that were found, whether technical in nature or more serious. Moreover, a study of this small a percentage of the total number of private pension plans would not substantiate a claim of systematic abuse. Consequently, although the report drew the analogy, insufficient information has been provided for an independent appraisal of the conclusion.

Although the system may not be in crisis, abuses do occur. It is, of course, important for the government to remain diligent against self-dealing, other kinds of fiduciary breaches and violations of other rules in the private pension system.

It is in this capacity that the government has chosen to target its enforcement activity against what has turned out to be predominantly small defined benefit plans. On its face, it might appear unfair to target enforcement on a subgroup in this manner. Nevertheless, targeting is imperative when resources for enforcement are limited. Every law enforcement agency in the country must target its investigations. Moreover, there is reason to focus efforts in this direction.

The Internal Revenue Service has focused on plans which have unusually large tax deductions per participant. According to the

Service, the average contribution per participant for defined benefit plans is $5000. The Service is examining those plans where the contributions are over $100,000 per participant. Indeed, the average of the plans examined to date is around $215,000. This extreme variance suggests the possibility of abuse -- the use of pension plans to shelter income beyond what was intended by Congress.

It is reasonable to anticipate that if large amounts of income are being improperly sheltered in this manner, small, closely held companies are more likely to engage in this conduct than large, publicly traded ones. The small company, which consists of a few highly paid professionals, who are founders and owners, and only one or two clericals, is in a position to structure a pension plan so that the owners can receive the bulk of the benefits while the clericals, for whom there is often much higher turnover, are likely to benefit very little. In that case, there is incentive to maximize contributions to the plan and the concomitant tax deductions, since the owners will probably glean the major, if not the total, benefit.

In contrast, in a large company, there is much more likely to be a pyramid structure, where there are many more rank-and-file employees than managers. In that case, even if there is more turnover among the rank-and-file, the bulk of the benefits would still go to that group. As a consequence, the incentive of management is to minimize, not maximize, pension benefits. Moreover, since the plan is not closely held, management does not have as great an ability to structure the plan to fit its interests.

As a consequence, if the government targets for investigation plans which claim unusually large per participant deductions, it is likely to focus disproportionately on small firms. Consistent with this assumption, the Service has found that over 97% of plans reporting contributions of over $100,000 per participant are plans with five or fewer participants.

The focus does not make the abuse any less real. One of the chief reasons that the government provides favorable tax treatment to qualified pension plans is to encourage employers to provide retirement income to low and moderate income workers. Individual retirement accounts have been limited in the size of the contributions allowed and the individuals who can contribute to them, in part in order to keep them from being merely a tax haven for the rich. Similarly, it is important that the government prevent group plans from being so abused.

While investigation of these kinds of potential abuses could discourage pension formation and could result in plan terminations, they nevertheless are important to pursue. Pension arrangements which offer few or no benefit to low and middle income workers but cost the Treasury large amounts in terms of revenue loss do not provide meaningful expanded coverage.

It may be, as some have charged, that the Service has been overly zealous, overly rigid or deceptive in the manner that the investigations have been pursued. If true, these are legitimate concerns and worthy of oversight. Nevertheless, they are not surprising charges from targets of an investigation.

The other issues raised by this Committee about systemic abuses -- the use of and the termination of pension funds in the context of hostile takeovers and leveraged buyouts -- are qualitatively different from those discussed above in this section. Rather, the topic fits more neatly under the final issue to be addressed -- the desirability of joint trusteeships for management of pension assets.

Joint Trusteeships

Issues such as whether pensions should be managed by boards of trustees composed partly of management appointees and partly of worker representatives and whether greater regulation of pension plans is warranted in the context of hostile takeovers are indicators of the changing role of pension funds in our economy. All of us who specialize in the area are aware of the changes. Nevertheless, we have not fully integrated the changes into our understanding.

Since the enactment of ERISA, the nation has witnessed an explosive growth in assets held by pension funds. In 1940, private pension funds held assets of $2.4 billion. In 1974, private pension fund assets totalled $212 billion. Today, the funds are approaching $1.6 trillion.

The explosive growth has been accompanied by a series of developments, practices and issues involving private pension funds to which many are uncertain how to respond. Pension funds have, for example, been used to thwart hostile takeovers. Plan sponsors have terminated overfunded pension plans in order to recover excess assets. Questions have arisen about who should control the attendant voting power associated with stock held in pension trusts, and about whether pension funds should engage in social investing.

These issues do not fall neatly under the heading of abusive conduct or unsoundness of the system. Rather, underlying all of them are fundamental questions concerning ownership of the assets, control of their use, and the purposes for which they should be employed.

Part of the difficulty in formulating widely acceptable solutions to these issues is that the existing framework for thinking about these problems is the trust model and the concomitant fiduciary rules. The trust model and the related fiduciary rules are well-suited to protecting workers against traditional forms of abuse, like self-dealing and imprudent investment. In the context of these more subtle issues, though, the trust model is inadequate.

Greater conflict and adverse interests exist between the settlor and trustees, on the one hand, and the beneficiaries, on the other, in a pension trust than in traditional trust arrangements. That is, in the case of pension trusts, the settlor and beneficiary are employer and employee, parties assumed by law to be adverse.

In recognition of the adversary quality of the relationship, the federal law has, outside the pension context, developed special rules and protections surrounding the employment relationship. In contrast, in the pension area, trustees are interposed to protect workers' interests. However, trustees may hold management positions, and, in any case, are appointed by management. As a consequence, the trust arrangement is an inadequate procedural safeguard to fully protect workers.

Furthermore, unlike most traditional trusts, the beneficiaries of a pension trust are generally quite numerous and any individual beneficiary's interest, quite remote. In many cases, the interest is contingent. Even when the interest is vested, the beneficiary may be ineligible to receive distributions until many years in the future. As a consequence, although the current legal scheme implicitly assumes pension beneficiaries will police fiduciary misconduct, the incentive to do so is inadequate.

The proposal for joint trusteeships of pension funds is a response to the recognition of the distinctive characteristics of large pension trust arrangements and the concern that trustees appointed by management may not be truly independent and may not truly reflect the interests of beneficiaries, notwithstanding their legal charge. Nevertheless, the joint trusteeship proposal may not be the best method of recognizing the special nature of pension trusts.

First, the proposal has conceptual problems. For example, trustees appointed by management are intended to be acting in the interests of the beneficiaries. If some of the trustees are appointed by beneficiaries, however, questions are raised regarding in whose interests the management-appointed trustees should be acting. Also, there are practical, operational questions, especially in nonunionized workforces, about how the trustees would be named. More fundamentally, though, the joint trusteeship proposal overlooks an even more fundamental difference between pension trusts and traditional trusts, a difference which too has been highlighted by the explosive growth in pension assets.

Traditional trusts are private arrangements between private parties. In contrast, pension trusts exert a dominant influence in our capital markets. Pension funds account for almost one-quarter of all outstanding corporate stock and almost 40 percent of all outstanding corporate bonds. Moreover, the favorable tax treatment accorded pension plans constitutes our nation's largest tax expenditure.

As a result of the huge size of pension assets, the impact they have on the economy and the large federal subsidy of these arrangements, the public has a strong third party interest in these arrangements. This third party interest, even more than the adversarial interests between the settlor-employer and the beneficiary-workers, differentiates pension arrangements from traditional trusts. I believe the joint trusteeship proposal has served a valuable purpose in focusing attention on the special nature of pension trusts. Nevertheless, a more far-reaching solution, which takes into account society's third-party interest, may be necessary to fully address the range of issues being stimulated by the size of pension funds. In that regard, we all must engage in more creative thought.

Conclusion

The issue of pension plan coverage can be divided into two parts: to what extent should policymakers propose reforms which could reduce coverage, and what, if any, affirmative steps can policymakers take to actively encourage further coverage.

Each of the topics of today's hearing raises complicated and important issues. Of all the topics, simplification is the only one that clearly will not diminish pension coverage and might result in its expansion. Nevertheless, the goal of increased coverage should not override other goals of ensuring the adequacy, equity and soundness of the pension system.

It is, of course, appropriate for policymakers to consider proposals for change in light of how they think employers will respond to them. The private pension system is voluntary; the best intentioned reforms have no value if they result in employers terminating their plans. At the same time, employers can conveniently argue that they will opt out of the system if a particular expensive, burdensome and otherwise unwanted change is enacted. Indeed, not surprisingly, employers have threatened plan terminations every time a major change in a retirement income program or policy has been proposed. To counter the threats of employers, those advocating progressive change must rely on policy arguments, dramatic cases of abuse, and mere assertions that employers are unlikely to terminate existing plans or refrain from establishing new ones.

Presumably, a point exists where the private pension system, as a whole, can bear no additional reforms, and pension plan coverage will shrink dramatically. Nevertheless, I do not believe a fear of reaching that point should cause policymakers to refrain from imposing requirements on these pension arrangements.

First, I do not think we are yet at that point. Long-range trends are hard to discern. It is true that overall coverage rates have stagnated for the last decade, but this period has been one of great volatility with respect to rules changes. Similarly, for a few years after the enactment of ERISA, there was a slowdown in pension plan formations and an increase in plan terminations.

More fundamentally, a national retirement income system should seek to ensure that the distribution of retirement benefits is fair, that their levels are adequate, within existing fiscal constraints, and that the monies used to fund them are secure. The government must continue to ensure that the system meets these criteria. If the system fails in these basic respects, the tax expenditure is unwarranted, and, worse, the promise of a secure retirement is illusory.

As I said at the outset, widespread coverage is an element of an adequate and fair retirement income system. While I do not believe the government should let this goal override other important goals, I do believe we should seek to find affirmative ways to expand coverage. Simplification should be pursued. Its limitations should be recognized, however. Moreover, Congress should be careful not to weaken fundamental protections in the name of simplification.

Additional tax incentives are the most viable solution to expanding coverage beyond its current levels. However, this solution is costly, may not work, and is difficult to target so that the incentives do not merely provide a windfall to those employers who otherwise would have provided pensions on their own without the additional inducement.

The best solutions might be to provide a stable environment, simplify where possible, continue to provide employees with incentives to save on their own when they are not covered by employer-sponsored plans and attempt to educate small firms about simplified employee plans and other relatively simple options.

Nonetheless, it is important to keep this issue in perspective. Employees of small firms do have some retirement income protection in the form of Social Security. Consequently, employees who lack both health insurance protection and supplemental pension protection are in greater need of the health insurance. Ensuring adequate health insurance protection should be the higher priority of policymakers.

PENSION PLAN PROBLEMS

By

DONALD S. GRUBBS, JR., F.S.A.

GRUBBS AND COMPANY, INC.

PRESENTED TO

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

JUNE 5, 1990

This presentation addresses the following problems concerning pension plans:

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The views expressed herein are solely my own and do not purport to represent any of the organizations with which I am affiliated.

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IRS AUDITS OF DEFINED BENEFIT PENSION PLANS

For defined benefit pension plans the Internal Revenue Service has the responsibility to monitor two aspects of the plans' funding - minimum funding requirements and maximum deductible limits.

The purpose of the minimum funding requirements is to assure that employers will contribute an amount sufficient to have the plans soundly funded.

The purpose of the maximum deductible limit is to assure that the amounts claimed as a deduction do not exceed the costs reasonably related to the particular year. Excessive deductions result in a taxpayer paying less than its fair share of taxes, ultimately requiring either an increase in taxes for other taxpayers or a reduction in governmental benefits and services to make up for the loss.

The Use of Actuarial Assumptions

Determining the cost attributable to a particular year depends upon assumptions the actuary makes regarding future rates of interest, mortality, salary increases, retirement age, and other factors. If the actuary were clairvoyant, he could use assumptions that reflect exactly what the future experience will be. Since he is not clairvoyant, the statute requires him to use actuarial assumptions and methods "which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

In addition, the statute requires that he use actuarial assumptions and methods "each of which is reasonable (taking into account the experience of the plan and reasonable expectations) ~~and~~ or which, in the aggregate, result in a total contribution equivalent to that which would be determined if each such assumption and method were reasonable."

If the actuary uses assumptions which are too optimistic, the contributions will be insufficient to provide the promised benefits. If the actuary uses assumptions which are too conservative, the employer will contribute more than is needed and will not pay its fair share of taxes.

Of course there are differences of opinion concerning what actual future experience will be concerning items such as interest rates and retirement age. However, there are limits on the range of what might be considered reasonable. Surely every one would agree that an interest assumption of 2% or 15% would be outside the range of reasonableness for a "best estimate of anticipated experience."

The reasonable expectation may vary from plan to plan. In a particular industry the average retirement age may be quite different than for other industries. A particular plan may be locked into investments for which the expected return is substantially higher or lower than average.

Furthermore, the law does not require that actuarial assumptions be individually reasonable if the assumptions are reasonable in the aggregate. Using an unreasonably low interest rate will tend to overstate plan costs, while using an unreasonably low assumption regarding salary increases will tend to understate costs. If the combined effect of using two such unreasonable assumptions is to produce costs approximately the same as if individually reasonable assumptions had been used, the assumptions are reasonable in the aggregate and they satisfy the requirements.

The Task of the Internal Revenue Service

The IRS has the difficult task of determining when a particular plan has stepped outside the realm of reasonableness. This task is made much more difficult because there are approximately 600,000 defined benefit pension plans, while the IRS has only a handful of actuaries in its national office who have expertise in determining the reasonableness of actuarial assumptions. Most IRS auditors in the 78 district offices are reasonably bright and conscientious individuals, but they are not qualified to determine whether actuarial assumptions are reasonable.

A significant number of small pension plans have been involved in abuse of the tax system, using overly conservative assumptions as a basis of claiming unreasonably high deductions on their tax return. In my opinion, the claim of a 1980 deduction of $619,925 for the annual cost of the pension for Jerome Mirza[1] was an egregious example, and I am aware of other similar cases.

At the same time, many plans are being funded in a responsible manner, using reasonable assumptions. The IRS needs an expeditious method of sorting out the tax abusers from the responsible taxpayers, without placing heavy administrative burdens on plan sponsors.

As a means of meeting its responsibilities to audit tax deductions, the IRS decided to focus on two areas of common abuse in the use of unreasonably conservative assumptions by small plans, the interest rate and the expected retirement age. IRS memoranda state that, in conducting audits of small plans, the auditor should not accept an interest assumption of less than 8 percent or a retirement age assumption of less than age 65 without approval from actuaries in the IRS national office.

While some, including me, may question the appropriateness of the particular assumptions, the general approach is appropriate. IRS auditors have simple guidelines by which they can automatically conclude that many plans have acceptable assumptions. Other plans using assumptions outside this range should be referred to the national office actuaries, who are qualified to determine whether they are appropriate.

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[1] Mirza and Associates Ltd. v. United States, CA 7, No. 80-2774, August 10, 1989.

Assumption of Interest Rate Earned under the Plan

The assumed rate of total investment return, including interest, dividends and realized and unrealized appreciation, is usually called the "interest" assumption. What is a reasonable interest assumption in today's world?

We are not primarily concerned with the rate of return in 1990, but with the expected rate of return over all years between the current valuation date and the date that all present employees receive their last benefit. As a practical matter, the rate of return assumed beyond 30 years usually has relatively little effect. The assumption applies not only to the assets on hand today, but also to the rate at which future cash flows may be invested.

For the overwhelming majority of plans, as a conservative estimate of expected investment return, it is useful to look at expected returns under long-term U.S. government bonds. While pension plans usually invest most or all of the plan assets in other forms of investment, these other forms of investment have generally had higher rates of return, which of course is usually why plan assets are invested in them. Thus the expected rate of return on government bonds is generally a conservative estimate of the expected rate of return on other investments.

The Washington Post reports that last week on May 31 the yield on 30-year Treasury bonds was 8.61%. Yields on these bonds have been consistently above 8% this year. For the 10 years ending with 1989 the average yield on long-term government bonds ranged from 8.14%

to 13.20%, with an average yield of 10.56%.

Today's yield of 8.61% results from the collective judgments of the thousands of investors buying and selling such bonds. As usual, yields on long-term bonds are currently slightly higher than those of intermediate and short-term bonds. In periods when investors expect long-term rates to fall, the opposite is true. Thus the collective judgement of Wall Street today is that no significant long-term drop in interest rates is expected. Thus the 8.61% rate is not only the interest rate that could be guaranteed for 30 years on today's investments; it is a marketplace judgement concerning future interest rates as well. As indicated earlier, the rates of return on alternative forms of investment are generally higher than for long-term bonds.

In light of these and other considerations, in my opinion it would currently be unreasonable to make a best estimate of the anticipated rate of investment return for the typical pension plan of less than 8%. I do not use less than 8% to determine the contributions to any of the plans for which I am the enrolled actuary. I believe that it is appropriate for the IRS to restrict automatic approval of the investment return assumption to those plans using 8% or more.

Plans using a lower interest assumption could refer the matter to the IRS actuaries in the national office. For some plans, there may be a valid reason to expect a rate of return less than those generally available in the marketplace. Another reason justifying a lower assumption might be to offset a salary increase assumption that is not conservative enough.

Assumptions of Interest Rate Used in Determining Benefits

In addition to its use in estimating the investment return under a plan, an interest rate is used for a second purpose - determining the amount of benefits payable in a form other than the normal form.

For example, a plan may provide that John Doe is entitled to receive a pension at age 65 of $1,000 monthly payable for his lifetime, or alternatively that he may receive a lump sum distribution determined to be the actuarial equivalent of this monthly pension. The plan is required to state the mortality and interest assumptions used to determine the actuarial equivalent amount, for example, the UP-1984 Mortality Table and 6% interest. In this example the amount of the lump sum distribution at age 65 would be $112,142. If the plan provides for these assumptions, it would be a violation of ERISA for the plan to pay any amount other than $112,142.

For purposes of determining the minimum funding requirements and the maximum deductible limit, the plan actuary must determine the current liability of the plan. The current liability is calculated by determining the amount of benefits expected to be paid under the plan in future years, and then determining the present value of these expected payments by discounting them to the present at interest. The IRS has declared[2] that, beginning in 1991, in determining the amount of benefits expected to be paid, the actuary must ignore the amount of the lump sum distribution required to be paid in accordance with the plan document and ERISA, and must instead calculate any lump sum distribution using the interest assumption that is used in discounting the benefits to determine their present value.

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[2] IRS Notice 90-11.

In a typical case, where 8% is used as the interest assumption for discounting benefits to determine their present value, the IRS would require in our previous example that the actuary pretend that the lump sum distribution is only $98,350, even though both the plan document and ERISA require that $112,142 actually be paid. This is absurd, and is fundamentally unsound. It undermines the sound funding of pension plans.

Retirement Age Assumptions

In the actuarial valuation of some large pension plans, the actuary often makes an assumption concerning the percentage of employees who will retire at each age where retirement is possible, e.g., the percentage who will retire at age 55, at age 56, etc. But for small pension plans the actuary instead usually makes an assumption concerning the average age at which all employees are assumed to retire.

This latter approach is entirely satisfactory, provided the average retirement age selected is reasonable as a best estimate of anticipated experience under the plan. But some plans have assumed a retirement age of 55 or lower when it is not reasonable to expect that employees would actually retire at such an early age. Use of an unreasonably early retirement age assumption may increase the amount of deductible contribution. Thus it is appropriate for the IRS to question the use of an unusually early retirement age assumption.

The IRS has chosen to question any assumed retirement age under 65.

Under the Social Security system it was estimated that in 1989 50.5% of all males age 62 and 62.1% of all females age 62 (an average of 56.3% for all 62-year-olds) who were eligible to retire had in fact retired. 68.8% of males and 79.0% of females were assumed to retire prior to age 65. The IRS is challenging any assumed retirement age under 65, even though the large majority of American workers actually retire before age 65, and most retire by age 62.

Experience under most private pension plans shows that only a very small percentage of participants generally retires before age 62. In some industries or occupations, however, earlier retirement is more common.

Thus it appears that age 62, not age 65, should be the age below which the assumed retirement age should be questioned. The actuary using an earlier assumed retirement age can provide information to the IRS national office actuaries as to why an earlier retirement age is to be expected in the particular industry, occupation or situation.

PROPOSED JOINT TRUSTEESHIP OF PENSION PLANS

The Hon. Peter Visclosky has proposed legislation that would require the assets held in trust for a single-employer plan to be held by a joint board of trustees, consisting of two or more trustees representing the interests of the employer and employees.

While this amendment sounds benevolent, it would actually be _very harmful to participants_.

Pension plans need professional fiduciaries to hold and invest plan assets. This is why I ordinarily recommend that a bank be named as trustee of the trust, and that either the bank which is trustee or a registered investment advisor be named investment manager. Most of the plans I work with have banks as trustees. Other approaches to obtaining professional investment management by institutions capable of safeguarding plan assets are (1) to use a group annuity contract issued by a life insurance company or (2) to use no-load mutual funds.

In most companies neither management nor employees have the knowledge, skill, experience and resources to hold and safeguard plan assets, account for them and invest them. If investment policy and investment decisions are determined by non-qualified persons - no matter how well intentioned - the expected result in many cases will be losses or a lower return on investments. I have often seen serious losses in trusts not managed by professional investment managers.

A second problem occurs for plans that cover a business where the only employee is the owner of the business. How can there be two or more trustees representing the employer and employees in this situation? And why?

A third problem involves small employers where no employee desires to be trustee. A plumber's helper might not want to become a trustee. He might feel unqualified. He might have no interest in learning about investments. If he understood the concept, he might want to avoid the fiduciary responsibility, including co-fiduciary responsibility, which accompanies being a trustee. What would the plan do if no employee is willing to accept trusteeship?

A fourth problem is the problem of misusing plan assets. In my experience over the years, I know of far more problems of actual abuse where there are individual trustees than where plan assets are held and managed by an insurance company under a group annuity contract or by a bank.

Mr. Visclosky's well intentioned proposal should be rejected as contrary to the interests of plan participants. If not rejected entirely, it should at least be made inapplicable to plans where all plan assets are (1) held by a bank trustee and managed by the trustee or a qualified investment manager, (2) invested in no-load mutual funds, or (3) invested in a group annuity contract of a life insurance company.

SIMPLIFICATION OF REQUIREMENTS

The regulatory requirements for pension plans are a complex and burdensome morass. They require enormous amounts to be spent by plans and their sponsors as unnecessary administrative expenses and fees to actuaries, lawyers and accountants, which could be better spent in providing more actual benefits or in increasing productivity. The requirements are so complex and confusing that it is often difficult to determine what is required. The complexity and the burdensome nature of the requirements have led to broad scale noncompliance with some aspects, and have made it impossible for the regulatory agencies to monitor or enforce compliance effectively. Worst of all, this has discouraged many small employers from establishing or maintaining plans.

Some of the requirements are needed. I was a strong advocate of legislation to establish minimum funding requirements and minimum vesting requirements for pension plans, and I continue to support legislation to assure that more employees receive an adequate retirement income. But much of the complexity is not needed to accomplish the simple objectives of protecting workers and assuring fair taxation.

The Association of Private Pension & Welfare Plans has prepared a paper, Gridlock: Pension Law in Crisis and The Road to Simplification. This paper addresses the problem in general and presents many specific suggestions for simplification. I highly commend this paper to any one who is serious about pension simplification, and I endorse almost all of its conclusions.

There are many additional steps that could be taken in simplifying the requirements, not covered in the Association's paper. I will discuss only two of them in the remainder of this presentation.

QUARTERLY CONTRIBUTION REQUIREMENT

Beginning in 1989 the Internal Revenue Code[3] requires pension contributions to be paid on a quarterly basis. For calendar year plans, the installments are due on April 15, July 15, October 15 and January 15.

Reason for the New Requirement

This new requirement came at the request of the Pension Benefit Guaranty Corporation (PBGC). In the absence of this requirement, contributions for a plan year can be paid as late as 8 1/2 months after the end of the year. PBGC was concerned that a plan might terminate after accruing benefits for part or all of the year, but without having received any contributions for the year, creating a problem for PBGC if the plan was underfunded and the employer was bankrupt and subsequently unable to make the contributions.

The Problem for Plan Sponsors

The primary problem for plan sponsors is that it is often extremely difficult or impossible to know what contribution is required in time to make the first quarterly installments. The problem is particularly difficult for calendar year plans, since most plans are calendar year plans and it is impossible for the plan actuaries to get all of the necessary valuations completed by April 15. In addition, this extreme time pressure created on actuaries causes them not to make the careful checks on their work that they ordinarily make, increasing the chance of error.

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[3] I.R.C. section 412(m), added by P.L. 100-203 (OBRA 98).

The prior year's valuation often provides little guidance in determining the current year's requirements. The application of the full funding limitation (a serious problem in itself) may cause the funding requirement to swing unpredictably from a very substantial amount one year to $0 the next, followed by another year with a very substantial funding requirement.

The employer would like to contribute the right amount by the deadline if the amount were known by then, but it is often impossible to know it. The employer is in a dilemma. If the employer makes no contributions when one is required, it faces adverse consequences. If it contributes and later discovers that the full funding limit was $0, it also faces adverse consequences.

Although only about 1 defined benefit plan in 10,000 terminates with unfunded guaranteed benefits in any year, the quarterly funding requirement designed to meet the potential problem applies to almost all defined benefit plans. Even for the few terminating plans affected, the solution would usually have little or no effect upon the amount of PBGC's loss.

The Solution

One solution would be to merely eliminate the quarterly contribution requirement, since its detriment clearly outweighs its benefits. If the requirement is not eliminated entirely, it needs to modified to make it more workable, while still responding to the concerns of PBGC.

The present quarterly payment requirement results in the average required payment being due August 31. Why not waive the requirement for all employers that pay 100% of the required contribution by August 31. By August 31, all employers could know for certain what the requirement is. The result would, on average, require payment of the contributions by the same date as the present requirements. This proposal would have no significant effect upon either revenues or the security of PBGC. It would solve the problem of employers.

SIMPLIFYING THE TAXATION OF DISTRIBUTIONS

Most payments from pension plans, like most other forms of income, are merely included in taxable income subject to usual tax rates. But if a distribution qualifies as a lump sum distribution, it is taxed under a five-year averaging rule, and may also be subject to two grandfather provisions.[4] Many taxpayers do not understand what distributions qualify for these three alternative treatments, or how the tax is to be calculated if the provisions apply. If a lump sum distribution includes pre-1974 accruals, the plan administrator must separately account for these and report them on Form 1099-R. If the lump sum distribution provisions apply in any way, the taxpayer must complete Form 4972 and attach it to his income tax return, a task which the IRS has estimated requires 3 hours and 17 minutes. Some taxpayers employ tax advisors at substantial expense to explain the alternatives and make elaborate projections under various assumptions to try to determine the best tax alternative.

I recommend that the special provisions concerning taxation of lump sum distributions be eliminated entirely, and that all distributions be included in taxable income subject to ordinary income tax.

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[4] I.R.C. section 402(e), TRA86 section 1122(h)(3),(5).

The suggested change would simplify a portion of the Internal Revenue Code which many taxpayers have difficulty understanding, and would actually shorten the Code itself, both worthwhile objectives. It would eliminate one IRS form and a lot of work for employers and taxpayers. It would save fees paid to tax advisors. It would also slightly reduce administrative costs for the IRS.

Increase Revenue

The suggested change would definitely increase tax revenue in the long run, and would probably increase revenue in the short run as well, depending on how many people change their behavior.

Preserve Pension Assets for Retirement Income Purposes

Consider John Doe, a participant who has just terminated employment. He is age 60 and single and has $18,000 of taxable income unrelated to pensions. Therefore he is in the 28% tax bracket. He reasonably expects to remain in the 28% bracket for the remainder of his life, or higher if tax rates are increased. Under his pension plan he is entitled to receive either a lump sum distribution of $90,000, or a deferred monthly pension beginning at age 65, or an immediate monthly pension, all three alternatives calculated to have equal value. If he elects a deferred monthly pension or an immediate monthly pension, he expects to pay 28% tax on the pension received. If he receives a lump sum distribution and rolls it over into an IRA to preserve it, he expects to pay 28% tax on the distribution whenever he eventually takes it out of the IRA, regardless of the form in which he receives it. But if he elects a lump sum distribution and does not roll it over into an IRA or another pension plan, he can elect five-year averaging treatment and only pay 15% tax. We have given John Doe a pretty strong incentive not to preserve his pension.

The special tax treatment of lump sum distributions is a disincentive to preserving pensions, either within existing plans or in rollover IRAs. If anything, the tax incentive should be exactly the opposite, encouraging individuals to preserve their pensions. The solution is simple. Eliminate the special tax treatment of lump sum distributions and tax all distributions from qualified plans as ordinary income.

Tax Equity

Elimination of favorable tax treatment for lump sum distributions would make taxes fairer. If John Doe is already in the 28% tax bracket, why should he pay only 15% tax on any income of any kind?

Transition Rules

Transition rules often create their own complexity, a problem to be avoided. If elimination of five-year averaging is too abrupt to be acceptable, the simple solution would be to reduce the 5 years to 4, 3 and 2 years in 1991, 1992, and 1993, and eliminate the provision entirely in 1994.

Elimination of the two existing grandfather rules would have little effect on the actual taxes paid, but would greatly simplify the law and the forms. 10-year averaging under the old tax rates (TRA86 §1122(h)(5)) usually is disadvantageous to taxpayers and is rarely used. The 20% capital gains tax for pre-74 money (TRA86 §1122(h)(3)) may or may not be beneficial, but usually applies to a relatively small portion of the distribution, if any.

CONCLUSION

My goal is to have every American receive an adequate retirement income, in a manner that is consistent with sound policies of taxation, employment and other key areas. Private pension plans have a vital role to play, but they are handicapped by an array of problems. This presentation addresses a few of these problems and possible solutions.

If I can be of assistance to Members of Congress or their staffs in working on these problems, I shall be glad to do so.

June 5, 1990

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

Portability, Joint Trusteeship, Simplification, Small Plan Audits, and Related Issues

by

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INTRODUCTION

My name is Leon Irish. I am a partner in the Washington, D.C. office of Jones, Day, Reavis & Pogue, where I specialize in employee benefits. I hold degrees from Stanford, the University of Michigan, and Oxford. I have practiced tax and employee benefits law in Washington for over 20 years. I am a past Chairman of the Employee Benefits Committee of the Tax Section of the American Bar Association and the ABA's Joint Committee on Employee Benefits. I have represented large and small employers, labor unions, governmental agencies, tax exempt employers, and trade associations in court and before the IRS, the Treasury, the PBGC, and the Labor Department. Beginning with ERISA, I have worked on virtually every Congressional enactment affecting employee benefits. I am a member of the Advisory Board of the BNA Pension Reporter, the Assistant Commissioner's Ad Hoc Working Group on Employee Benefits, and the American Law Institute. The views I offer today are strictly my own and should not be attributed to my law firm or its clients.

PORTABILITY

The term "portability" has become a tent under which people have sought to bring a number of disparate problems. Several of these deserve the serious attention of this Committee as it considers possible ways in which to enhance the private pension system, especially for small business.

1. Portability as Lack of Immediate Vesting. A 1988 Department of Labor (DOL) study examined the extent to which employees lose pension benefits because they change jobs. It concluded, somewhat surprisingly, that losses due to deferred vesting are insubstantial, at least since the adoption of tax rules requiring full vesting in five years. I say "surprising," for it seems to me certain that many members of our highly itinerant workforce, especially the unskilled, the young, and many of those employed by small businesses, must fail ever to accumulate any meaningful private pension benefits because they do not stay long enough at any job to vest.

Perhaps the reason that the DOL study showed that loss of pension benefits for this group is insubstantial is that this group never accumulates more than insubstantial pension benefits. That problem might properly receive the attention of this Committee, but it is a problem of vesting and not one of true "portability." Requiring full, immediate vesting under all pension plans would provide protection for the most itinerant members of the workforce. Doing this would be consistent with the "wage" (as opposed to the "gratuity" or "insurance") theory of pensions. It would, however, eliminate one of the principal ways in which employers can still design retirement plans to induce employees to remain on the job.

2. Slower Vesting in Multiemployer Plans. One vesting rule that deserves special attention from this Committee is the special rule allowing vesting to be deferred for 10 years rather than 5 in a multiemployer plan. I realize that this is a highly political issue, but it is difficult to see any reason to treat employees covered by multiemployer plans less generously than those covered by single employer plans. If it is the case that hardly any employees lose benefits because vesting under multiemployer plans can be deferred twice as long, than it will cost almost nothing to apply the five-year rule to them as well. If it would cost a lot to make the change, that merely demonstrates that requiring five-year vesting would benefit many employees covered by multiemployer plans, and why should they be less well protected than others?

3. Portability Losses Due to Lump Sum Distributions. The 1988 DOL study concluded that two-thirds of what it called "portability losses" resulted from pension benefits being distributed to participants prior to retirement, usually in connection with a change of jobs. In order to ease the administrative and recordkeeping burden on plan sponsors, ERISA and the Code allow small pension benefits --

those less than $3,500 -- to be distributed to employees when they separate from service at any age, and pension benefits of greater amounts may be distributed upon separation from service at any age with the concurrence of the employee.

Of course, the mere fact that pension benefits are distributed in a lump sum to those leaving one job for another does not mean that they cannot be kept intact as part of the individual's pension. Congress has wisely provided that such distributions may be "rolled over" tax free to an individual retirement account ("IRA") or to another qualified plan. The rules for rollovers, however, are unduly complex, technical, and rigid. They should be made simpler and more generous, in part to encourage rollovers and in part to achieve greater fairness and simplicity.

Desirable as such improvements in the rollover rules would be, however, they would not solve the "portability" problem caused by early lump sum distributions. The sad fact is that most people cannot resist spending pension distributions that they receive before retirement, and that this tendency is greatest among the lowest paid, the very people who need more rather than less coverage under the private pension system. Apparently eighty percent of pre-retirement lump sum distributions are spent rather than being rolled over. In addition, although hard data are not available, it is known that the availability and permissibility of lump sum distributions upon reaching retirement age causes many individuals to dissipate their retirement benefits rather than using them as an income supplement during their retirement years.

4. Three Proposals. Several steps should be considered to alleviate this problem. First, Congress should repeal the special five-year averaging rule, which gives preferential tax treatment to lump sum distributions, thereby encouraging them and discouraging rollovers. Second, Congress should consider prohibiting lump sum distributions from most pension plans except in the case of death. Third, Congress should consider creating a National Employees Savings Trust (NEST), so that employers could be relieved of the burden of maintaining pension accounts for former employees and so that employees could accumulate all of the bits and pieces of their private pensions in one safe place. Each of these ideas is controversial and, to some extent, unpopular. Below I have tried to sketch out how they could be made to work in a simple, sensible way. First, however, it is appropriate to say something by way of overall justification.

a. Reasons Not to Change. There have been so many recent changes in the laws affecting pension plans that a very good case can be made for deferring any further changes, large or small, good or bad, simply to allow the overburdened pension community some time to absorb the changes that have already been made. Further, proposals that would take away from individuals popular benefits that have been in the law for a long time -- lump sum distributions and tax averaging -- are controversial on at least three substantive counts: First, no one likes to be the one to take away a popular benefit, even if doing so is ultimately for the good of the system and the individuals it is designed to benefit and protect. Second, as a firm believer in letting individuals have choices and manage their own affairs, it is with real reluctance that I advocate changes that would diminish those choices. Third, although repealing five-year income averaging would be a modest revenue raiser, a general prohibition on lump sum distributions would be a revenue loser, at least in the short term. Although these are substantial objections, they are on balance overcome in the current circumstances because the recommended changes would materially enhance the private pension system.

b. The Basis for the Private Pension System. As is widely known, the private, voluntary pension system constitutes one of the largest "tax expenditures" in the tax expenditure budget. Unquestionably, we would collect much more revenue if we did not allow current deductions for pension contributions, tax exempt status for pension funds, and tax deferral for individuals until they receive their pension distributions. It is appropriate and justifiable to defer the taxation of qualified pensions, however, and thus to collect less revenue in real dollar terms, because doing so encourages voluntary savings for retirement. In a voluntary system, tax incentives are necessary to encourage people to do what they should do in any event -- save for their old age.

c. Repealing income averaging and lump sum distributions. The availability of income averaging and lump sum distributions, both before and at retirement, however, undermines the rationale for the pension system and causes a "leakage" from the system that is unacceptable in light of the many billions of foregone revenue dollars we spend on it. It would strengthen the integrity of the pension system and better justify the tax expenditure incurred to support it, if Congress acted to insure that monies put away for retirement are used only for retirement purposes. By repealing income averaging and lump sum distributions, Congress would eliminate the cause of two-thirds of the portability losses of the current system and would make it more likely that employees, especially those who move from job to job, will have meaningful private pensions when they reach retirement. For these combined reasons, I believe that the recommended changes should be considered seriously.

d. A NEST for employee pensions. With respect to the proposed National Employees Savings Trust, or NEST, the proposal that should receive the closest attention of this Committee is the one that has been made by my co-panelist and respected friend of many years, Don Grubbs. In testimony before the Oversight Subcommittee of the House Ways and Means Committee on July 12, 1988, Don proposed a "Federal Portable

Pension Fund." I would rename Don's proposal, not merely to offer a perhaps more appealing acronym, but also to emphasize certain key respects in which my proposal would differ from his.

Under the Grubbs proposal, each plan sponsor could choose whether or not to allow pension accumulations to be transferred to the federal portability fund upon a separation from service other than for death, disability, or retirement. In order to strengthen the integrity of the pension system, I would make the availability of transfers to the federal portability fund -- which I here call the NEST -- mandatory for all retirement plans, with one important exception. Lump sum distributions from retirement plans would be eliminated. Employers would be required to give employees who separate from service for any reason, including disability or retirement, the right to transfer their pension accumulations to the NEST. Plan sponsors could also allow employees the choice of leaving those accumulations, or only those that are $3,500 or more, in the plan. The amount to be transferred would be calculated under the same rules currently in force for calculating the amount of cashouts. Plans would be required to identify any portion of a transfer amount that constituted employee contributions, just as under current law.

There should be one major exception to the requirement that cashouts be repealed and transfers to the federal portability fund be made available under all qualified retirement plans. Many defined contribution plans are designed as long-term savings plans, not as retirement plans, and many employers maintain both a retirement plan, usually a defined benefit plan, and a savings plan, often a section 401(k) cash or deferred plan. I would retain the rules of current law, under which cashouts and lump sum distributions are available from savings plans, but only for defined contribution plans and then only where the employer is maintaining a meaningful retirement plan for the same employee. A meaningful plan could be defined as one meeting the minimum benefit and contribution requirements under section 416 of the Code. Under these plans, and perhaps under defined benefit plans as well, in order to alleviate problems caused by the elimination of lump sum distributions, employers would be allowed to offer hardship distributions or loans.

Although transfers to the NEST would be required for both defined benefit and defined contribution plans, with the exception mentioned for supplemental savings plans, all pension accumulations transferred to the NEST would be maintained as defined contribution accounts. This is necessary in order to avoid complex problems that Don has described in detail and which I will not repeat here. Converting all transferred amounts to defined contribution accounts not only greatly simplifies the administration of the NEST, it would solve one of the key problems of portability. By having such funds invested at positive rates of return, their value will grow. This would solve the problem of deferred vested defined benefit pensions, which actually diminish in real economic value because determined by reference to a participant's salary at separation from service rather than at retirement.

Following the Grubbs proposal, I would allow distributions from the NEST only in the form of a cash refund annuities, either on a single or joint life basis; no lump sums would be permitted, even at retirement. Distributions could commence no earlier than age 55 and would automatically start when the individual elects to receive Social Security or age 70, whichever is later. The administrator of the fund would determine the actuarial factors to be used in determining the amount of annuity distributions, but such distributions should include an annual 4 percent cost-of-living adjustment in order to protect retirees against inflation. Any amounts remaining after the individual dies, whether before or after retirement, would be paid to his or her designated beneficiary, but a transfer could be made to a nonspousal beneficiary of a married participant, as under present law, only with the consent of the spouse.

With respect to the investment of the funds, I would differ somewhat from the Grubbs' proposal. Although the NEST should be maintained by a separate trust or agency established by the federal government, the funds should be invested and managed by private sector money managers chosen on the basis of competitive bids. The administrator of the NEST should establish three or four carefully designed funds -- say, a bond fund, a mixed income fund, a stock growth fund and a government securities fund -- and participants would be allowed to elect which fund to have their account invested in and to shift annually between funds. All elections would be subject to reasonable minimums, and the government securities fund could be the default fund in the absence of an election.

The cost of administering the NEST would be charged against participants accounts, though perhaps with a small subsidy from the federal government in the start-up years. Transfers to the fund would be tax free and all distributions from the fund would be taxable as ordinary income.

e. Summary of proposals. Although there are many details that would require careful study and detailed drafting, the overall purpose and effect of prohibiting lump sum distributions and cashouts (except in supplemental savings plans) and allowing transfers to a National Employees' Savings Trust are clear:

1. Repeal of the provisions allowing cashouts and lump sum distributions would eliminate two-thirds of the portability pension losses.

2, Repeal of lump sums (and the income tax averaging rules for them), even at retirement, except for supplemental savings plans, would ensure that the private pension system more nearly accomplishes its objective -- the provision of retirement income over the remaining lives of workers after they retire.

3. Creating a National Employees' Saving Trust (NEST) will remove from employers the burden of maintaining small pension amounts for former employees while simultaneously allowing employees to save, invest, and consolidate all pension accumulations that they become entitled to during their working lives.

4. By allowing employees to convert deferred vested defined benefit pensions to defined contribution accounts that can be invested and that will continue to grow until distributed, the proposals would address another key portability concern -- the fact that defined benefit pensions are typically much less for the worker who holds a number of jobs than for the worker who stays at one job for his or her career.

5. By having the NEST funds invested by private money managers and the administrative costs be borne by the NEST, the proposal would not move pension funds into government hands or increase the cost of the system.

The proposals made here would not solve all of the problems that have been raised by others under the rubric of "portability." For example, the only "perfect" solution to the problem of pensions that are diminished for those who work under several defined benefit arrangements is to require each employer to provide each piece of a participant's pension on the basis of his or her final average pay before retirement, not on his or her final average pay for that employer. Such a requirement, however, would require all but the last employer to, in effect, accrue greater pension benefits for the years worked by a departed employee than for a similarly situated employee who stayed. In addition to the perceived unfairness of such a rule, it would also be a clear step in the direction of mandated pensions, a step that I do not believe the Congress is prepared to consider at the present time. This political fact is perhaps itself unfortunate, for the key problem of the private system -- the lack of meaningful coverage for nearly half the private workforce -- probably cannot be solved short of a mandatory system, a subject on which I have presented views in another forum.

The proposals made here do address the core of the portability problem, though, and they do so by dealing directly with the unfortunate fact of our current system. As long as employees are allowed to receive their pensions in lump sum distributions most of those monies, accumulated on a tax-advantaged basis for retirement, will be spent and dissipated for nonpension purposes. Eliminating lump sums and providing for rollovers to a National Employees' Savings Trust will solve this problem.

JOINT TRUSTEESHIP

Mr. Visclosky has triggered a firestorm of debate with his proposal (H.R. 2664) that pension plans be required to have joint labor and management boards of trustees. The labor movement has by-in-large supported this proposal while the business community has been united in its opposition. Congress has been divided; the Bush Administration has come out strongly in opposition. Rarely, though, has a proposal caused more heated debate.

Although I do not support Mr. Visclosky's amendment, for many of the reasons that others have already made clear to this Committee and elsewhere, I think we must pay close attention to the fact that his proposal has caused so much heated debate. The old adage that where there is smoke there is fire deserves to be remembered. Even if his proposal is not the best solution, clearly the virulence of the rhetoric brought to bear on his proposal suggests that Mr. Visclosky has uncovered an important issue.

1. Defects of the Visclosky bill. The critics of Mr. Visclosky's bill rightly contend that enactment of it would politicize pension management. Instead of neutral and disinterested trustees carrying out their responsibilities for the exclusive benefit of plan participants and their beneficiaries, pension trusteeships would become additional battlefields in the frequently hostile and counterproductive warfare between unions and management. No one who has witnesses the growing trend of labor and management trustees of Taft-Hartley plans hiring separate counsel so that they can more vigorously and effectively represent the different and often conflicting interests of their different constituencies -- with the pension fund itself bearing the double burden of these counsel fees -- can doubt that joint labor-management trusteeship engenders conflict and a partisan approach to the important business of managing pension plans. I am afraid I simply do not share the overly

optimistic view that mandating another area in which labor and management must work together will create greater harmony rather than more friction.

Another important reason to oppose the Visclosky bill is that it would inevitably increase the pressure for so-called "social investing." American workers are worried -- indeed rightly worried -- about losing jobs. Through their union representatives they have demonstrated a strong desire to see pension assets used to preserve and create jobs with their employers or in their industry. They would like to see job preservation and creation accepted as a legitimate reason for selecting one pension investment over another. This strong tendency of workers and their union representatives -- euphemistically called "social investing" -- has been rightly and vigorously resisted by the Department of Labor. Under both Democrat and Republican administrations the heads of the ERISA program at DOL, whether they have come from a labor or management background, have clearly stated that pension investing must be done solely by reference to standard investment criteria appropriate for pension plans, such as risk, yield, and diversification. Job preservation or creation can be taken into account to choose one investment over another only after the alternative investments have been determined to be equal on purely investment-oriented criteria.

Despite the clear -- and, I would add, clearly correct -- position of the Department of Labor against "social investing," my experience and impression is that a great deal of it goes on surreptitiously in pension funds dominated by unions. By forcing equal worker or union representation on each board of trustees, the Visclosky bill would dramatically expand the number of pension funds that will be subjected to pressure to make investments that will preserve or create jobs, even when those investments are less sound from the perspective of appropriate pension investment criteria.

2. Employer bias. These are powerful reasons, in my judgment, for opposing the Visclosky amendment. Yet their very statement reveals the problem that Mr. Visclosky has rightly perceived. There is another old adage that is just as true as the first: "Where you sit determines where you stand." Just as union or worker trustees would inevitably bring the bias of their constituency to their roles as trustees, the fact is that there are hundreds of thousands of pension plans in this country whose trustees are officers or employees of the employer maintaining the plan and who bring to their role as trustee the inevitable bias of the employer.

Let me be very clear at this point that I am not accusing either labor or management trustees of illegality or wrongdoing. Most individuals who serve as trustees do their work well and honestly. The actual incidence of illegal manipulation of pension funds in the interests of either an employer or union is surprisingly small. The point, however, is that, to use the words of Emily Dickinson, one can "tell the truth, but tell it slant." Whether an individual works for a labor union or a business corporation, human nature is such that there will often be a conscious or unconscious bias in favor of one's employer.

Indeed, this conflict of interest is so apparent that the Congress that enacted ERISA and prohibited transactions that involved self dealing, favoring parties with adverse interests, or any form of "kickback" also felt impelled to enact section 408(c)(3). Under this provision nothing in the prohibited transaction rules is to prohibit an officer, employee, or agent, or other representative of a party in interest, such as an employer, from serving as a fiduciary of a plan. Without this provision, it would be probably illegal under ERISA for company officers or employees to serve as ERISA trustees, at least where there is a conflict of interest.

Despite the apparent clarity of ERISA section 408(c)(3), the Department has long contended that an officer or employee of the employer has a conflict of interest that debars him from continuing as a fiduciary in such circumstances as a hostile tender offer for shares of the company where the plan has invested in employer securities. Despite losing its effort to get the courts to adopt a per se rule to this effect, such as the Bierwirth case in the Second

Circuit, it is my understanding that the Department continues to regard such double loyalties as unacceptable under ERISA.

3. Recommendation: Repeal ERISA § 408(c)(3). The short of all this is that Mr. Visclosky has uncovered a real problem but proposed the wrong solution. Rather than creating tensions and conflicts in the administration of pension plans by requiring that their governance become another battleground for workers and management, Congress should repeal section 408(c)(3). We now have enough experience to know, and ought to have enough candor to admit, that despite the pious possibility that an individual who is an officer or director of a company can also objectively perform his or her duties as a fiduciary acting exclusively in the interests of plan participants and beneficiaries, in all too many cases plan fiduciaries who are employed by the company in fact act in the interests of the employer rather than the interests of the plan participants. This is true not only in such dramatic but infrequent events as hostile takeovers or proxy fights, where the plan may hold the shares that could swing the contest either way, but also in the more mundane, day-to-day questions of benefit claims administration.

It has always been the case that plan administrators employed by the company tend to take a pro-company position in resolving disputes concerning the interpretation or application of a pension plan. That problem has heightened importance now that the Supreme Court has ruled, in Firestone v. Bruch, that courts must generally defer to discretionary decisions of a plan administrator unless they are arbitrary or capricious. The Court also indicated that a lesser standard may be applicable in reviewing cases where the plan administrator has a conflict of interest, but failed to say what that standard would be or to define what a "conflict" is.

It is important to emphasize that ordinary matters of plan administration and recordkeeping would not have to be done by an independent third party if section 408(c)(3) of ERISA were repealed. These are primarily ministerial rather than discretionary or substantive matters, and though they must be done carefully and well under the prudence standard of section 404(a)(4), no conflict of interest is created if the employer does them "in house" rather than contracting them out.

4. Effect on Large Employers. Repealing section 408(c)(3) would affect most large employers in only isolated ways. Large employers already typically retain independent institutional trustees and investment managers. A few companies retain investment control over part or all of their assets. Many of the companies that have retained investment authority over some or all plan assets can rightly claim that they have outperformed the rather lackluster performance of the typical pension fund investment manager. In my experience, however, it is also true that these companies

sometimes use impermissible criteria in selecting or retaining investments. For example, pension funds may be used to support the stock of suppliers or customers of the employer, to take a position in a company that is a possible acquisition target, or to provide a "window" on certain technologies of possible importance to the employer. These objectives are every bit as improper as pension investment criteria as are the preservation or creation of jobs. Requiring that all investment decisions for pension plans be made by fiduciaries who are independent of the employer will eliminate this kind of improper use of pension assets.

For most large plans, the major change caused by repealing section 408(c)(3) will be to require benefits claims disputes to be handled by independent fiduciaries rather than by employees of the company. Although this would be a substantial change, it is difficult to see why the employer should serve as both judge and jury in disputes between the plan and a participant, especially when many of those disputes involve issues on which the employer has a direct or indirect interest that conflicts with the interest of the employee. The ordinary administration of the plan, up to the point where a dispute is uncovered, could continue to be handled by the employer. It should therefore not involve significant cost to use independent fiduciaries, in this case perhaps individuals rather than institutions, to process benefit claims disputes. If the plan gives these independent fiduciaries discretion to interpret and apply the plan -- as perhaps it must in order to meet the "full and fair review" standard of ERISA section 503(2) -- then it is all the more important that the reviewing fiduciaries be independent of the employer, for under Bruch there will be little chance of judicial review of discretionary decisions.

Repeal of section 408(c)(3) would cause one other significant change for large plans. It would become impermissible for officers or employees to act as fiduciaries with respect to ESOP's or other employer stock-funded plans, or to sit on management committees that retained the right to vote the employer securities in such plans. Although this would be an important change, it is a highly desirable one. It would at last put a stop to one of the most blatant and least defensible conflict situations permissible under current law.

5. Effect on Small Plans. Although repealing section 408(c)(3) would require large plans to make some significant changes, these changes would seem desirable in almost all respects, and any additional costs would probably not be significant. For small plans the cost and burden of requiring independent fiduciaries for the investment, management, and claims administration of the plan could be more severe. It might be that exceptions should be made for one-person plans or plans covering only highly-compensated employees. For small plans covering non-highly compensated

persons, however, there are probably reasonable alternatives through various group investment and administration arrangements to obtain independent fiduciaries at a reasonable cost. It is hard to see why conflicts that should not exist in large plans should be tolerated in small ones, at least so long as there are better alternatives that are not unreasonably expensive. This Committee would want to study these questions before adopting a specific legislative proposal.

In sum, there is a serious problem in permitting the fiduciaries charged with investing and administering plans to be officers or employees of the employer, but the right solution is not to require that equally but differently biased employee representatives be added to the board of trustees. Rather, section 408(b)(3) should be repealed so that all discretionary decisions affecting a plan are made by independent fiduciaries, who have no conflict of interest.

SIMPLIFICATION

For ten years I have been urging pension simplification, at conferences, in my work with the Bar, and in articles I have written. During that ten years we have seen the greatest increase in the number and complexity of the laws governing pensions that has ever occurred. This trend is enough to induce skepticism in the most optimistic soul, so, though I laud the current concern over complexity, I will wait to see what concrete results it produces.

1. Current Proposals. Today I would like to say three things about simplification. First, it is difficult to offer views on current proposals. We are still waiting to see proposals that should be forthcoming soon from Senator Pryor and Chairman Rostenkowski. It is my understanding that one or perhaps both bills will propose simplification in the areas of discrimination testing for cash-or-deferred plans and taxation of plan distributions. These are both areas in which substantial simplification is both greatly needed and eminently possible. Although specific reactions cannot be offered until these proposals have been introduced, I certainly endorse the approach -- taking specific areas of the law and seeking to simplify them without making major changes in underlying policy.

The changes I have recommended today -- repeal of income averaging and abolition of lump sum distributions -- would substantially simplify the rules for pension distributions. These changes would also represent substantial policy changes, however, and I offer them primarily for that purpose, not as mere simplifications. As Congress proceeds to examine various simplification proposals, it will have to be vigilant in sorting out proposals that are really policy changes disguised as simplification.

2. What is Simplification? Second, it is important to understand that simplification is itself not an easy or

self-explanatory concept. I have attached to my statement an article I wrote over ten years ago which attempts to get to the bottom of what "simplification" really is. Here I will merely repeat the conclusion of that article:

> Simplification is not as simple as it sounds. Indeed, what looks like simplification may not be. The complexity and precision of fully articulated rules may be simpler -- because more certain and predictable in application -- than rules that look and sound simple. Mechanical rules are generally simpler in this sense than those whose application requires judgment or discretion, and priority should be given to making pension laws more nearly self-enforcing. The system can, in fact, tolerate a lot of complexity at the plan level. Other values, such as freedom of choice and fairness, should not be sacrificed for mere simplicity, and change itself is a complexity that should be avoided.
>
> In sum, any proposed simplification must bear the triple burden of showing (1) that the proposed simplification is real, not apparent, (2) that the benefits of simplification outweigh the other virtues of current law, and (3) that the benefits of simplification outweigh the disadvantages of change. In the end, simplification is a complicated business, and one suspects that, although we pension lawyers may be simple, the pension laws will never be.

3. Simplification -- and Law Making -- Through Regulations. Finally, I would direct your attention to the mammoth regulation package promulgated by the IRS on May 10, 1990. This set of regulations supplies all but one of the remaining sets of rules needed to implement the changes made by the Tax Reform Act of 1986 and in 1989 in TAMRA. (The important separate line of business rules are yet to come.) In addition to being extremely well written, carefully thought out, and clearly organized, these important

regulations also represent a very important effort to provide simplification in the rules governing pension plans.

The regulations in this so-called "section 401(a)(4)" regulation package propose a number of design-based safe harbors. Employers that decide to adopt these safe harbors will find the task of pension compliance greatly simplified. At the same time, however, this package spells out new interpretations of a provision that has been in the Code for over 40 years -- interpretations that are both novel and with which it would be extremely expensive and difficult to comply. These general rules are so complex and onerous that they will, if finalized as they have been proposed, have the necessary effect of driving many if not most employers into the simple safe harbors.

Although I have only begun the process of trying to absorb and understand the section 401(a)(4) regulation package, my initial reaction is that it embodies a set of rules that is sound from a policy point of view and that will simplify pension law considerably. It also represents a remarkable and daring effort at comprehensive rulemaking by the IRS.

Proposed under the most important Code provision governing pensions that was not changed by Congress in 1986 -- the prohibition against discrimination in benefits or contributions in favor of the highly paid -- these regulations put forward rules well beyond anything contemplated by the Congress that enacted section 401(a)(4) or that can honestly be said to have been contemplated in the 1986 Tax Reform Act. Certainly, section 401(a)(4) has been interpreted and applied quite differently by both practitioners and the IRS for more than 40 years. If Congress is content to have the pension experts at the IRS and Treasury assume basic responsibility for policy changes in this area in the guise of issuing interpretative regulations, than it may well applaud these important proposed regulations. Given their breathtaking scope, however, and the enormous impact they are sure to have, including impact on small employers, this Committee may want to take a hard look at the section 401(a)(4) regulation package and consider whether it is willing to accept this ambitious attempt by the IRS to change pension law through regulation rather than Congressional enactment.

SMALL PLAN AUDITS

On November 29, 1989, the Acting Director of the EP/EO Operations Division in the National Office of the IRS sent to all Regional and District offices directions on auditing small plans that included the following statements:

> 2) If plan costs are based on a joint and survivor annuity, the post retirement interest rate should be 8 per cent.
>
> 3) Challenge all assumed retirement ages of less than 65 unless you know the individual has already retired or, in the extremely rare case, believe he will (not might) be retiring at that age.

This directive brought a firestorm of inquiries from the field, and, on January 19, 1990, the Acting Director send out revised guidance that indicated that field agents should contact particular personnel in National Office if they believed that an interest rate of less than 8 percent or a retirement age of less than 65 would be appropriate in a particular case.

After obtaining these documents under the Freedom of Information Act, the American Society of Pension Actuaries stated in a widely distributed letter that, "the IRS has embarked on an illegal and abusive program directed against small defined benefit plans" and that the second memorandum was merely "designed to give the small plan audit program the appearance of some flexibility." This is just a sample of the intense feelings and emotionally charged rhetoric that surrounds this controversy.

Once the province of large companies and collectively bargained employment situations, by the end of the 1980's several hundred thousand defined benefit plans had been been set up to cover just one to five participants. Many of the highest income individuals in America -- including many doctors and lawyers -- established these defined benefit plans and claimed individual deductions that in many cases exceeded $500,000 for a single year.

Alarmed by this emerging practice, the IRS initiated a special small plan audit program in the mid-1980's. There has been a major increase in these audits fairly recently; currently the IRS has audited or is in the process of examining 18,000 small plan cases. In these audits the IRS has asserted millions of dollars of deficiencies on four principal grounds: (1) using an inappropriate funding method, (2) exceeding the maximum benefit limitation under section 415, (3) using an unreasonably low interest rate in calculating funding, and (4) using an unreasonable early retirement age. To the extent that these issues are litigated or settled in favor of the IRS, additional interesting issues will arise concerning the interpretation and application of Code provisions imposing penalties for claiming excess pension deductions or overstating pension liabilities.

The IRS small plan audit program received a major boost when the federal District Court for the Central District of Illinois agreed that 5 percent was an unreasonable interest rate for funding, at least when safe investments were yielding 12 percent or better, and that it was not reasonable to seek to deduct in a single year contributions for past years of service totaling over $625,000. In August 1989 the Seventh Circuit affirmed the Mirza decision, and, just three weeks ago, the Supreme Court denied certiorari.

There are 35 cases currently in litigation involving these issues. Some fourteen Tax Court cases recently scheduled for trial in California were settled with agreements to pay an average of 90 percent of the claimed deficiencies. Other taxpayers, however, have vowed to fight the deficiencies asserted by the IRS, claiming, inter alia, that the IRS (allegedly as indicated by the memorandum of November 29, 1990) has taken a rigid position that actuarial assumptions for funding purposes must include interest rates that are at least 8 percent and retirement ages that are, except in the rarest cases, 65. They contend that these rigid positions violate the Code, which requires flexibility with respect to actuarial factors depending upon the particular facts and circumstances. Additionally, it is claimed that the IRS must defer to the professional judgment of qualified actuaries and that the IRS is disregarding its own prior rulings and audit guidelines.

In its defense the IRS has argued that it has selected cases upon the basis of the size of claimed deductions, not on the use of particular interest rate or retirement age assumptions. It contends that a substantial number of cases in which such assumptions were used were not, once examined, selected for audit, and that a substantial number of cases involving asserted deficiencies where these assumptions have been used have been contested on other grounds, primarily violations of section 415 or use of an improper method. The

IRS stoutly contends that it uses a facts and circumstances approach rather than rigid guidelines and that any taxpayer that is not satisfied with the treatment he or she receives in the field can seek technical advice in the national office. Indeed, Assistant Commissioner Robert Brauer has taken the unusual step of offering to review personally cases closed after audit where the taxpayer feels that the field followed a rigid approach rather than a facts and circumstances approach.

Recently, Judge Charles Clapp of the U.S. Tax Court has been assigned to handle all Tax Court cases involving small plan audits. On May 15th he met with lawyers representing the IRS and a number of interested taxpayers to discuss possible selection of test cases to litigate, on facts satisfactory to all concerned, the various issues arising from these audits. My understanding is that considerable progress toward that end has been made but that no definitive agreements or arrangements have been reached for conducting test case litigation of selected cases or for establishing that the decisions reached would govern other similar cases. With Assistant Commissioner Brauer's permission, I have attached to this statement a letter recently received by me and other members of his Ad Hoc Working Group on Employee Benefits which, together with an attached memorandum, sets forth the background and issues involved in this small plan audit program from the IRS perceive.

Senator Rudy Boschwitz has proposed legislation which would require the IRS to accept all methods and assumptions used by actuaries in determining the funding of defined benefit plan if they are consistent with IRS audit guidelines that were in effect at the time. My understanding is that proponents of this legislation look particularly to a provision of the general audit guidelines promulgated for field use by the National Office in 1984, which indicated that IRS agents should not challenge particular actuarial assumptions, such as interest rates and retirement ages, until the plan had been in existence for at least three years and specific experience had been established under the plan. To my knowledge, no similar legislation yet has been introduced in the House.

The IRS has responded that the 1984 guidance was general and not directed specifically to small plans, that the IRS in 1985 and 1986 issued 15 technical advice memorandums dealing with small plan actuarial issues, and that the 1984 guidelines are specific in stating that they were "not . . . all inclusive" and that they "may be modified on the basis of actual examination issues encountered."

It is with considerable temerity that I now attempt to suggest some appropriate views and perspectives on this "red hot" controversy that is engaging the minds and passions of some of the most talented people in the pension business, both in the IRS and in the private sector. First, it is clear that it considerably oversimplifies the dispute to think that it involves the question whether the IRS can rigidly insist on 8 percent and age 65 as actuarial funding assumptions. The IRS seems not be taking such a rigid position; indeed. Assistant Commissioner Brauer states in the attached letter that the National Office has been allowing the use of ages and interest rates less than 65 and 8 percent in a significant majority of the cases referred to it by the field. In reality, there are a variety of issues involved in the small plan audit program, a number of them are quite complex technically. For example, it was not until 1985 that the IRS clarified, in Rev. Rul. 85-131, that under the unit credit method the costs of benefits must be apportioned between service in the present year and service in prior years. It is also puzzling to taxpayers to have the IRS challenging the use of 5 percent interest factors for funding defined benefit plans when Rev. Rul. 76-464 provides assurance that the use of interest rates between 5 and 6 percent for target benefit plans is acceptable. Further, there seems to be considerable disagreement about the facts surrounding the program in general and considerable variation in the facts of particular cases.

In this context, I feel able to offer only two general observations, one aimed at the IRS and the other at Congress. Whatever the merits or demerits of particular positions the IRS has taken in connection with the small plan audit program, it seems clear that it might have done a better job of heading off this problem. To those who practice in the field, it has been clear for more than a decade that very aggressive plan design and funding practices were developing in the small plan community, especially with respect to high income individuals. Before the problem ballooned to the stage where tens of thousands of plans had been created and funded in ways which the IRS now regards as impermissible, it would have been appropriate to issue some form of public notice or guidance that would alert the pension community and those whom it advises that the IRS regarded many of the emerging practices as highly questionable. Issues like the use of unreasonably low interest rates or assumed retirement ages should have been discussed and the IRS point of view exposed to public knowledge and scrutiny.

To use yet another old adage, "an ounce of prevention is worth a pound of cure." If the IRS had acted sooner, more clearly, and more publically with respect to the small plan problem, it would not have grown to the extent that it has. In this context, I do not think that internal audit guidelines or pleadings in docketed cases, even if publically available, constitute adequate notice. Prominent lawyers, doctors, and others would not have been lulled into thinking that the aggressive plan funding assumptions and methods now being attacked were permissible. If the future judicial resolution of these cases follows the pattern set by the Mirza case and the 14 cases recently settled in California, taxpayers who thought they were on sound ground will have to pay millions more dollars in taxes and the reputations of leading professionals who designed these plans or participated in them could be besmirched. It is really not enough in these circumstances to say that this just another example of the "pig" principle of tax law and that those involved in these so-called "abusive" small plans should have known better. It seems to me that the IRS has an obligation to alert the taxpaying public of emerging issues and concerns in a timely and appropriate fashion, and that it did not meet that obligation fully or well in this instance.

With respect to Congress, I would like to express my strong opinion that it is wholly inappropriate for the Congress to intervene in matters that are before the courts. Once cases are sub judice it is imperative under our Constitution and essential to the integrity of our system that independent courts adjudicate ripened cases and controversies free of legislative interference. Congress should not, in other words, pass bills that directly or indirectly affect the outcome of decided cases.

Beyond this, it is in my opinion inappropriate for the Congress to direct the executive agencies in the way in which they are to accomplish tasks assigned to them. Congress cannot possibly know or anticipate the complex facts and circumstances that surround the interpretation and application of the laws of general application which it passes. Our system works best when Congress, and not an agency, creates the law, the agency interprets and applies it, and the courts oversee disputes and set aside the acts of both Congress and the agencies when they exceed the Constitution or the laws.

Without question the courts are fully equipped to oversee the correctness and propriety with which the IRS has sought to administer the law in these small plan audits. Just as I would strongly like to see this Congress, and not the IRS and Treasury, determine what the law is with respect to Code section 401(a)(4) and the rule prohibiting discrimination in favor of the highly paid with respect to contributions or benefits (see the Simplification discussion above), so too I believe that is inappropriate for Congress to intrude itself into the IRS's proper role of auditing tax returns and proposing deficiencies where it thinks appropriate or into the role of the courts as the final arbiters of disputes. If I may offer yet one more old adage, both Congress and the IRS should "stick to their own knitting" and not try to do the work of the other.

CONCLUSION

That concludes my prepared remarks. Thank you for offering me this opportunity to share my thoughts with you. I will be pleased to attempt to clarify what I have said or to answer any questions.

Leon E. Irish
Tax Group
(Employee Benefits Section)

Washington, D.C., Partner. Born Superior, Wisconsin 06-19-38. Admitted 1965 California; 1968 District of Columbia. Stanford University (B.A. 1960); The University of Michigan (Law Review; Order of the Coif; J.D. 1964); Oxford University (D.Phil. 1973). Law Clerk to Justice Byron R. White, United States Supreme Court (1967-1968 term); Consultant, Office of Foreign Direct Investments, U.S. Department of Commerce (1968-1969); Adjunct Professor, Georgetown University (1977-1985); Professor of Law, The University of Michigan (1985-1988); Special Representative, Secretary of Defense, U.N. Conference on the Law of the Sea (1978). Joined Jones Day 1988.

Lee Irish has experience in all aspects of employee benefits and international law, including trade, finance, and development in Eastern Europe.

He is a member of the ABA (Taxation Section, Past Chairman: Employee Benefits Committee; Joint Committee on Employee Benefits). He is listed in *Who's Who* and *Who's Who in America Law*, is a trustee of two Eastern European foundations, and is a member of The American Law Institute and the Council on Foreign Relations. He served as a Regent of the American College of Tax Counsel and a member of the Commissioner's Advisory Group.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

ASSISTANT COMMISSIONER
(EMPLOYEE PLANS AND
EXEMPT ORGANIZATIONS)

MAY 2 5 1990

Leon E. Irish
Jones, Day, Reavis
& Pogue
1450 G Street, N.W.
Washington, DC 20005-2088

Dear Practitioner Committee Member:

I have spoken to a number of you in the past several days regarding the desirability of disseminating information concerning our defined benefit plan actuarial examination program. Enclosed is a description of the program which expands upon the substance of my remarks at a press briefing held on April 3.

The program is designed to examine approximately 18,000 returns over a three year period, during which over one half million returns were filed by defined benefit plans with one to five participants. This 18,000 number is even smaller than it may appear because many of our examinations encompass several plan years, each of which is included in the 18,000 figure. Indeed, we estimate that we have contacted more than half of the parties we will be examining over the course of this program.

I want to be sure you are aware that the basis for initial selection of these cases for audit is the amount of plan deduction per participant claimed on the return, not the so-called 8 percent/age 65 issue. Once the case is selected for audit, our agents look into all issues relating to the plan's funding, including adherence to the section 415 limits, funding methods, and interest and retirement age assumptions.

You may also be interested to learn that in a significant number of the cases in which we disallow deductions, the interest rate and retirement age issues either do not come into play or are not the determinative factors in the case. This is because the use of an improper funding method or violation of the section 415 limitations often results in the plan exceeding its full funding limit. Once this occurs, no deduction is permitted in that plan year. A correction of the method or the 415 violation creates a zero allowable deduction without reaching the age or interest rate issues.

I hope any experiences you may be having with examinations under this program will confirm my view that our agents and actuaries are considering each case on its merits. My conversations with many of you in recent days indicate that your personal experience with these audits is that my agents have indeed judged each case on its merits, and have deviated from the 8 percent/age 65 guideline where it was appropriate to do so. Yet, many of you who have recounted that experience to me have also indicated that you perceive, based on conversations with others, that the Service is not being as flexible on interest rate/retirement age issues as it should be. In this regard, I can only repeat that the instructions given to my field offices require that the facts and circumstances of each case be considered before reaching a decision. Through mid-May, our National Office actuaries were allowing ages and interest rates of less than 65 and 8 percent, respectively, in the significant majority of the cases referred to them.

We of course encourage all taxpayers to request technical advice from the National Office where they believe our agents' conclusions are incorrect. To those who perceive that our agents are adhering too strictly to the 8 percent/age 65 guideline, I particularly recommend the technical advice route if the matter cannot be resolved satisfactorily through the National Office actuary contact. Additionally, my offer to personally review any case closed by one of my field offices where the facts and circumstances approach was not followed has been widely publicized. To date, only three such cases have come to my attention.

I encourage you to share with me any comments you may have on this program, pro or con. I find your input extremely helpful and sincerely welcome it. I invite you to call me at (202)566-3171 with any thoughts you would like to share.

I have no objection at all to your sharing this letter and the attached information with your colleagues.

Sincerely,

Robert Brauer

Robert I. Brauer

Enclosure

DEFINED BENEFIT PLAN EXAMINATION PROGRAM

The program has as its basis a longstanding effort to address what the Service considers to be questionable tax practices in the case of a small number of defined benefit plans. Specifically, the Service is questioning the funding of defined benefit plans where the annual pension contribution claimed per participant indicates that the actuaries may have exceeded the contribution limits for any of several reasons including:

1. using an inappropriate funding method,
2. exceeding the maximum benefit limitation under section 415,
3. employing an unreasonably low interest rate not supported by the facts and circumstances of the plan. (In the plans adjusted among the first 500 cases closed, the average interest rate used was 5.2%), or
4. employing an unreasonably low retirement age not supported by the facts and circumstances of the plan. (In the plans adjusted among the first 500 cases closed, the average retirement age used was 57.)

In a substantial number of our cases, all or most of the contribution is disallowed due to the "legal issues" listed above (e.g., funding method or section 415) without ever reaching the interest rate and retirement age assumption issues.

Contributions to these plans are tax deductible. By utilizing one or more of the practices cited above, employers can take excessive deductions. Such deductions may come to hundreds of thousands of dollars annually per plan.

LITIGATION HISTORY

In the summer of 1988, the United States District Court for the Central District of Illinois decided in the Service's favor in a case called Mirza v. United States. The Seventh Circuit Court of Appeals affirmed this decision unanimously in August 1989. The court held that an actuary must base his funding assumptions on "experience and reasonable expectations". Among other things, the plan in Mirza utilized a 5% assumption at a time, when safe investments were yielding 12% or more. The Court also found that the actuary had improperly applied the chosen funding method. In Mirza, the appellate court disallowed $510,000 in deductions claimed for the one year in question (1980). On May 14, 1990, the United States Supreme Court denied the taxpayer's petition for certiorari.

The Service's position with respect to the reasonableness of actuarial assumptions is that they are determined on the facts and circumstances of the particular case. This was the position that the Service took in Mirza and it continues to be our position.

In addition to the Mirza case, we have had 35 cases in litigation on these issues. Every case that has been completed has been resolved on terms highly favorable to the government. Fifteen Tax Court cases that were on the docket for trial in March in California were recently settled for an average of 90% of the claimed deficiency. Of the 20 court cases now resolved, $3.2 million has been disallowed, an average of $160,000 per case.

PROGRAM SCOPE

The program is designed so that only 18,000 returns are examined out of a universe of over a half million. The primary selection criterion used is amount of annual contribution per participant, not interest rate or normal retirement age. The program was expanded late in 1989. The expansion was based on the convergence of three events: (1) the appeals court decision in Mirza, (2) our developing the ability to identify with some precision the filers who are claiming the largest deductions for contributions to these plans (thereby indicating the possibility that questionable actuarial assumptions may be used), and (3) our developing computer programs which enhance the skills of our agents to conduct audits of these plans. The program has been identified as one of the Service's Management Initiatives and is included as such in the President's 1991 budget.

We want to emphasize that the Service would conduct this program even if it were not identified separately in the budget. As indicated by the significance of the disallowed deductions in the Mirza case and in the cases that have been settled to date, we would be remiss if we did not vigorously pursue these issues.

Our research shows that over 98% of plans reporting over $100,000 in contributions per participant (that segment of plans that is more likely to employ the questionable practices noted above) are in the 1-5 participant plan sector. Within the universe of the hundreds of thousands of defined benefit plans that are not under examination, the average retirement age and interest rate assumptions used by actuaries are significantly higher than the average age and interest rate of 57 and 5.2%, respectively, for plans in which the Service made an adjustment as a result of our examinations. In those few situations in past years where we have found a large plan employing questionable funding method and actuarial assumptions of this sort, we have taken steps to correct the problem - - that is, we disallow deductions where appropriate.

EXAMINATION RESULTS

The average contribution per participant to a defined benefit plan is less than $5,000. In the first 500 cases which our agents have completed examining, the average annual pension deduction claimed was $215,000, with eleven individuals claiming over $600,000 in annual pension deductions and thirty-eight others claiming over $300,000. In these cases, the average adjustment recommended by the agent was $194,000. Our experience thus far shows that over two-thirds of our cases involve plans of doctors and lawyers; the rest consists of other highly paid individuals.

INSTRUCTIONS TO FIELD OFFICES

Early instructions to our regional offices (which advise field agents to challenge interest rates below 8% and retirement age assumptions of less than 65) were written as a guidepost to our field agents to help ensure that a consistent approach was being employed in the treatment of a complicated area with a proven need for review, and to provide a mechanism for separating clearly allowable deductions from others. When some suggested that this initial guidance might be applied without consideration of facts and circumstances of individual cases, instructions were issued to clarify this aspect of the program.

FLEXIBILITY

As in any examination, taxpayers and their representatives are free to present the facts and circumstances used in developing their assumptions. Our procedures provide a method for a field agent to consult with a National Office actuary about the adjustment of assumptions in particular cases. Such consultations are frequent. Through mid-May, our National Office actuaries were allowing retirement ages and interest rates of less than 65 and 8%, respectively, in a significant majority of cases referred to them. In addition to the opportunities available to present the facts and circumstances to our agents, taxpayers and their representatives are free to request technical advice from the National Office if they feel their positions have not been fairly or correctly evaluated.

Of the first 500 cases closed, our agents allowed interest rates of less than 8% in 30% of cases and retirement ages of less than 65 in 20% of cases. In addition, 15% of cases originally selected for examination are closed without taxpayer contact based solely on the review of the facts and circumstances available in our return files. Others are closed without change after a review of the material provided by the taxpayer.

Some have suggested to us that, particularly during the early stages of this program, cases may have been processed without proper consideration of facts and circumstances. Therefore, in addition to the normal appeal rights to which taxpayers are entitled, the Assistant Commissioner for Employee Plan matters, Robert Brauer, has offered publicly to personally review any case closed by one of our field offices in which the facts and circumstances of the specific case were not considered.

TAXPAYER CONCERNS

There have been concerns expressed that the Service is not adhering to its own rulings, notices, and regulations in its conduct of this program. We have thoroughly reviewed each of these concerns and have the following comments on those concerns that have received the most attention.

Some practitioners believe that the Service, under section 412, is required to defer to the actuary (and allow claimed deductions for a pension contribution) even though the Service believes that the actuarial assumptions upon which that contribution deduction was based were unreasonable. As with other aspects of a taxpayer's reported tax liability, the general enforcement and administrative responsibilities conferred upon the Service empower it to question the correctness of a deduction taken for pension plan contributions. Moreover, in enacting section 412, we believe Congress made it clear that it expected the Service to examine actuarial issues and make any needed adjustments. In our view, Congress did not purport or intend to delegate control over the determination of the employer's tax liability to the sole discretion of the employer and its actuary. To the extent that claimed deductions rest on actuarial assumptions, the Service has the responsibility to question the reasonableness of those assumptions within the meaning of section 412.

Claims that the Service is applying new rules retroactively and not adhering to the audit guidelines put into the Internal Revenue Manual in 1984 are not, in our view, supported by the stated purpose of the guidelines or other Service issuances. In 1985 and 1986, the Service issued fifteen technical advice memorandums that dealt with the same issues covered in this program. These memorandums provided focused analyses of the practices at issue. They encompassed the same interest rate, retirement age, and section 415 issues as are covered in the current program. These documents were widely circulated and discussed by Service officials at practitioner meetings.

On the other hand, audit guidelines such as those issued in 1984 serve the purpose of providing our agents general rules for identifying and addressing certain violations and for assisting in the development of audit issues where no specific area of concern has previously been identified. They do not preclude a more focused and complete examination of issues. Guidelines are simply management tools designed to assist field personnel in allocating and utilizing resources. The Service would be remiss if it allowed nonbinding guidelines to preclude the development of examination efforts directed at areas which we consider potentially abusive. As stated in the guidelines themselves:

> "Because of the diversity of conditions encountered during examinations, these guidelines are not devised to be all inclusive or restrictive."
>
> "These guidelines are not intended to be all inclusive; consequently, the techniques identified in this handbook may be modified based on the actual examination issues encountered."
>
> "It is expected that the guidelines and worksheets will help the examining specialist decide on what areas to concentrate and when to utilize the various worksheets with respect to particular plans. However, the (guidelines), Worksheets and explanations, do not cover every problem that could arise under the minimum funding standard or deductible limits, and the specialist is in no way limited to raising questions relating to only those problems identified." (underlining added.)

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What Is Simplification?

LEON E. IRISH

The proposal to simplify ERISA has immediate appeal, and one would not want to appear to be an advocate of greater complexity. "Simplification" is not a self-evident concept, however, and the question of what makes one set of laws simple and another complicated deserves separate attention.

Ideally, it would seem that simple pension laws should be few in number, easy to understand, and certain in their application. However, there are many reasons for doubting whether such laws could be attained, and other reasons for doubting whether they would be desirable. Without attempting a systematic analysis of "simplification," the following discussion offers some general observations.

Simplicity, Clarity, and Technical Elaboration

A frequent criticism of ERISA is that it is long, complicated, full of technical jargon, and difficult to understand. It is tempting to think that ERISA would be much simpler if it were stated briefly in plain, clear language. Stating the law simply, however, does not necessarily simplify the law.

There is no doubt that the easiest way to get the general thrust of an idea is to encounter it first in simple terms (*e.g.*, "A qualified pension plan must primarily provide for systematic benefits after retirement"). Simple words and plain statements, however, often lack precision. Because simple, everyday words serve many purposes and often carry multiple meanings and connotations, their actual meaning in a given context may be quite uncertain. Technical words, perhaps specifically defined for the purpose, are often clearer than "simple" words. And, while spare and simple state-

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ments are usually the best means for expressing the core thought of a complex idea, completeness and accuracy often demand elaboration. Thus, to the extent that "simplification" involves being clear and precise in the statement of the law, it may mandate full, technical articulation rather than epigrammatic terseness.

Simplicity and Generality

The "simplest" statements are often those that are most general (*e.g.*, "A qualified plan must be maintained for the exclusive benefit of employees and their beneficiaries"). To be intelligible as law, however, such general statements must be broken down and their constituent concepts analyzed and understood (*e.g.*, does "exclusive" preclude other benefits? Does "employees" include retirees?). To the extent that the law is stated in general terms, those who are regulated by it, or charged with applying it, must try to figure out what it really means. To the extent that intelligibility is a goal of "simplification," it is again preferable to have fully articulated rules whose meaning is clear, rather than "simple," general statements that must be puzzled out.

Simple Laws v. Complex Realities

When the events or transactions that a law seeks to regulate are diverse and complex, a simple law may be worse than no law at all. For example, Code Sections 414 (b) and (c) require treating all employees of commonly controlled trades or businesses as employees of a single trade or business for purposes of Code Sections 401, 410, 411, and 415. This rule is simply but not imprecisely stated, and its generality does not leave us uncertain of the idea being expressed. Indeed, the rule seems all too clear. Rather than dealing selectively with discrete problems that arise in the area of common control (*e.g.*, separating the production and management personnel of the same business into two separate corporations with a plan only for the latter), Code Sections 414 (b) and (c) impose a rigid rule on all situations involving common control. In doing so this simple rule ignores the complexities of what it deals with (*e.g.*, a conglomerate that acquires a subsidiary with an unrelated trade or business and no pension plan). In cases like this, the law might be improved by having, instead of one "simple" rule, a number of specific rules tailored to deal with particular problems.

Few v. Many

As laws become more focused and more fully articulated, however, they also become more numerous. Eventually a point is reached where there are so many rules that only a specialist can keep track of them all.

If the multiplication of rules continued—and there is no finite limit to the number of rules that can be created for regulating pension plans—they would overwhelm even the specialist by the sheer weight of numbers, and the system would collapse. As in architecture, there is in law a point where less is more.

Thus, while "simplification" may sometimes mean substituting several specific rules that pick out particular problems for a single rule that is too sweeping, here "simplification" means cutting down on the sheer number of rules. There is no easy way to reconcile the tension between these competing methods of simplification.

Arbitrary v. Flexible Rules

The application of rules is simplified by establishing objective criteria that are easy to apply. Such mechanical rules, however, often do an imperfect job of picking out the cases actually intended to be covered by the rule. If, on the other hand, the rule by its terms only bestows benefits or imposes burdens on actual instances of what is intended to be fostered or prohibited, then the rule is likely to be phrased in terms that have uncertain meaning or are difficult to apply. The antidiscrimination rules provide examples of both kinds of rules. It is generally a sure and easy matter to determine whether a plan meets the Code Section 410 (b) (1) (A) 70% or 80%/70% eligibility tests, but many plans that do not discriminate in favor of the prohibited group do not meet these mechanical tests. By contrast, Code Section 401 (a) (4) denies qualified status to plans that discriminate in favor of the prohibited group in terms of contributions or benefits. Because it is phrased in terms of the substantive evil it is intended to eliminate, rather than in terms of easily ascertainable indicia of it, it is very hard to predict the application of this rule. (Compare with this Code Section 415, which employs arbitrary dollar and percentage limits to prevent qualified plans from being used to provide excessive benefits rather than making "excessive" itself the legal standard.) Here, then, there would seem to be a straight trade-off between simplicity—in the form of mechanical rules—and flexibility—in the form of rules that aim exclusively and directly at the substantive good to be promoted or evil to be prohibited. To choose simplicity here is necessarily to choose a rule that is easy to apply but which is imperfectly broad or narrow in preference to a rule that can be employed flexibly and with judgment to reach neither more nor less than what is intended to be covered.

Self-Enforcing v. Administered Rules

No legal rule is wholly self-enforcing, but a system of laws is measurably "simpler" to the extent that it employs rules that are as close to self-enforcing as possible. One example is provided by Code Section 401 (a) (8), which denies qualified status to a trust that permits forfeitures to increase a participant's benefits. Putting this rule in the Code virtually assures that it will be inserted in the trust document of every plan intended to qualify, and its presence in those trusts virtually assures that it will be complied with. By contrast, a plan which seeks qualified status on the ground that it satisfies the reasonable classification test of Code Section 410 (b) (1) (B) must affirmatively demonstrate to IRS that, on a fair cross-section analysis, it does not discriminate in favor of the prohibited group. A legal requirement for advance governmental approval is perhaps the most extreme example of a rule which requires extensive administration.

Every system of rules depends in part for its efficacy on the fact that the government regularly checks for compliance. To the extent that rules are unclear, imprecise, too general, overly broad, or require the exercise of discretion or judgment in their application, any apparent simplicity in the rules as stated is swallowed up in application by the complexities and vagaries of compliance audits and the attempts by regulatees to predict and guard against those audits. Accordingly, any attempt to simplify the pension laws should give primary emphasis to increasing the predictability of the laws and reducing the extent to which they must be administered to be effective.

Simplicity v. Choice

Another clear-cut trade-off appears to exist between certain kinds of simplicity and the choices people are given. To the extent that different kinds of qualified plans are permitted (pension, stock bonus, profit-sharing, TRASOPs, group IRAs, etc.), there will have to be different rules for them. To the extent that individuals are permitted to choose whether or not there will be survivor's benefits, there will have to be relatively complex rules for making the appropriate elections. To the extent that we permit a wide variety of distributions from qualified plans (annuity payments, lump sums, rollovers, employer securities, annuity contracts), the rules for taxing these distributions will be relatively complex. This is not to say that there could not be greater simplicity within the existing framework of choices, but merely that, at a fundamental level, the decision to permit diversity and choice is, to a measurable extent, a decision against simplicity.

Simplification for Whom?

Many people are affected by the pension laws, but they do not all have an equal stake in simplification. The distinctions that can be drawn here, though, are not entirely easy. It is tempting to say that lawyers, accountants, actuaries, and other pension professionals are paid for their technical expertise and therefore do not need simplification. Indeed, one of the functions played by these professionals is to translate selectively the complexities of law, accounting, actuarial science, and government regulations into sufficiently few and simple terms so that employers and employees can understand and cope with them. (Perhaps a relevant question here is not why the government has not simplified ERISA but why the professions have not done a better job of boiling it down and communicating it to clients in a way they can understand and deal with.) The pension laws are now so numerous and complex, however, that probably only professionals who specialize in them can advise clients adequately. Yet many nonspecialists are asked by small employers for advice on what kind of qualified plan to set up, if any, and nearly any lawyer or accountant can be called on to deal with the taxation of plan distributions. In ERISA areas where nonspecialists have to advise clients, therefore, simplification may be important at least for these professionals as well as for employees and employers.

It is equally tempting to argue that the government regulators have no stake in greater simplicity. Their whole job is to interpret and apply the laws, and they are given large budgets and staffs to do it. At the field level, however, the pension laws are administered by ordinary men and women. If the pension laws are now so numerous and complex that these people cannot reasonably be expected to understand, remember, and fairly apply them, then it is no longer possible for Congress' objectives to be achieved and simplification is in order.

On the other hand, by chance or design the pension system is one of the areas of economic life where complexity can be tolerated (in the interests of the fairness and choice it permits). Pension plans pool the money of many individuals, and the bulk of pension laws can be dealt with at the plan level. By dealing on a centralized basis with the legal problems of financing retirement income by private means, pension plans achieve economies of scale. In other areas affecting individual income taxation such complexity would be intolerable. But sizeable pension plans, or their sponsors, can reasonably afford to hire the professional assistance needed to design and operate plans optimally and in compliance with the law.

This argument, of course, does not meet all of the complaints about complexity. For example, it carries no weight when one is dealing with plans of small employers or the tax problems of plan participants. If the taxation of distributions were simplified, however, and truly simple qualified plan possibilities were made available to small employers, then perhaps the remaining complexities would seem more tolerable.

Every Change Is a Complexity

To accomplish a substantial simplification of the pension laws it would be necessary to make substantial changes. It takes considerable time and effort for the pension community to absorb changes. Changes that would require requalification of plans would impose heavy burdens on plan sponsors. In short, every change is a complexity and should be resisted for that reason.

Conclusion

Simplification is not as simple as it sounds. Indeed, what looks like simplification may not be. The complexity and precision of fully articulated rules may be simpler—because more certain and predictable in application—than rules that look and sound simple. Mechanical rules are generally simpler in this sense than those whose application requires judgment or discretion, and priority should be given to making pension laws more nearly self-enforcing. The system can, in fact, tolerate a lot of complexity at the plan level. Other values, such as freedom of choice and fairness, should not be sacrificed for mere simplicity, and change itself is a complexity that should be avoided.

In sum, any proposed simplification must bear the triple burden of showing (1) that the proposed simplification is real, not apparent, (2) that the benefits of simplification outweigh the other virtues of current law, and (3) that the benefits of simplification outweigh the disadvantages of change. In the end, simplification is a complicated business, and one suspects that, although we pension lawyers may be simple, the pension laws will never be.

EBRI

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Statement

Before the Committee on Small Business of

The U.S. House of Representatives

Hearing on

Pension Plan Issues

by

Dallas L. Salisbury
President
Employee Benefit Research Institute

Washington, D.C.
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STATEMENT OF DALLAS SALISBURY
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SUMMARY

- EBRI has undertaken extensive analysis over the past 12 years to track and assess pension trends. Three facts emerge: first, small employers are moving away from defined benefit plans; second, they are not immediately replacing them with defined contribution plans; and third, the cost of administering plans relative to the amount that can be contributed has been eroding.

- Since the enactment of ERISA, a steady stream of legislation has greatly influenced pension programs. From the Revenue Act of 1978 to the Omnibus Budget Reconciliation Act of 1989, Congress has changed some aspect of the retirement system almost annually. It is complicated and expensive to maintain a plan. Simplification of the law and regulations could make a difference.

- Pension legislation has served to increase the security of benefits for those with coverage, and it has created many jobs. It has not led to an increase in the proportion of workers covered by pension plans.

- Employer-sponsored pension plans represent an important source of retirement income for most working Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement, in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of all these participants, or 32 million workers, were entitled to a benefit at retirement.

- Increasingly, there has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975.

- The gap in private-sector pension coverage for workers is largely among small employers. The latest data indicate that more than 68 percent of full-time employees in companies with 250 or more employees participate in retirement plans, while, by contrast, only 16 percent of full-time employees in companies with less than 24 employees do so. The reduced tax rates of TRA 1986, combined with the funding limitations of OBRA 1987, have made plans much less attractive from the tax perspective. Small employers have never sponsored plans in large numbers and the present environment makes it unlikely that this will change.

- Pending legislative proposals such as joint trusteeship, regardless of the merits, would add cost and complexity. While it is unlikely that the proposal itself has influenced behavior, adoption certainly would.

- Portability concerns are merited, but only if those concerns lead to preservation of pension dollars into retirement. Today, nearly all defined contribution plans provide for lump sum distributions upon job change. Over 40 percent of private defined benefit plans provide for lump sums, and the number is growing each year. Individuals, however, do not roll-over distributions (13 percent did in 1988). Legal changes which have increased the number of lump sums (such as five year vesting) have served to discourage pension sponsorship as small businesses state a preference to pay longer service workers extra cash rather than watching pension dollars walk out the door with short service workers.

- Finally, it should be stressed that the pension system is in a strong financial position today and that it is one of the most heavily regulated financial "institutions". Comparisons to the situation with Savings and Loans are without merit. Pension fund participation in mergers and acquisitions has largely been by public pension funds, which are not subject to the fiduciary provisions of ERISA. The agencies charged with administration of ERISA have worked hard to regulate fully and fairly, even though greater clarity and brevity in regulations and guidance, and prospective application when changes are made in policy, would serve to encourage plan sponsorship and continuation.

STATEMENT OF DALLAS SALISBURY
PRESIDENT
EMPLOYEE BENEFIT RESEARCH INSTITUTE
BEFORE THE COMMITTEE ON SMALL BUSINESS OF
THE U.S. HOUSE OF REPRESENTATIVES
JUNE 5, 1990

I am pleased to appear before you this morning to review the rules governing private pension plans and their possible impact on pension participation and coverage. My name is Dallas Salisbury. I am the president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC. EBRI has long been committed to the accurate statistical analysis of public policy benefits issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies.

Pension Law

For over 50 years, the federal government has sought to encourage the establishment of pension plans through tax incentives. At the same time, public policy has been directed toward ensuring that plans are financially sound and equitable. Some observers have questioned whether these changes are having the unintended effect of impeding pension growth. Because pension plan administration has become such a complex and expensive field, some fear that recent legislation has eroded employers' incentives to provide pension plans. Others suggest that since plan provision is very limited in small businesses, additional incentives are needed to bolster pension coverage in the future.

EBRI has undertaken extensive analysis over the past 12 years to track and assess pension trends. Three facts are particularly clear: first, small employers are moving away from defined benefit plans; second, they are not immediately replacing them with defined contribution plans; and third, the cost of administering plans relative to the amount that can be contributed has been eroding.

Early legislation such as the Revenue Act of 1921 and the Revenue Act of 1926 first provided tax-deferred status to pensions. In particular, profit sharing plans gave employers the flexibility to forgo contributions in those years in which profits were low. The Self-Employed Individuals Tax Retirement Act of 1962 allowed small unincorporated business owners to start pension plans for themselves and their employees for the first time through Keogh plans.

The Employee Retirement Income Security Act of 1974 (ERISA), however, represents the most important landmark in pension legislation. ERISA provided participation and vesting standards, fiduciary and funding requirements, and it strengthened reporting and disclosure rules. In general, ERISA focused on safeguards for pension plan participants.

Since the enactment of ERISA, a steady stream of legislation has greatly influenced pension programs. From the Revenue Act of 1978 to the Omnibus Budget Reconciliation Act of 1989, Congress has changed some aspect of the retirement system almost annually.

The Revenue Act of 1978 expanded the opportunity to save for retirement on a tax-preferred basis by permitting employers to establish 401(k) arrangements. Through

401(k) arrangements, participants may contribute a portion of compensation to a qualified employer-sponsored plan. Typically, the contribution is made as a pretax deduction in (or deferral of) salary that is paid into the plan by the employer on behalf of the employee.

The Revenue Act of 1978 also created simplified employee pensions (SEPs) as a low cost way for small employers to start a pension plan.

The Economic Recovery Act of 1981 (ERTA) raised Keogh plan contribution and benefit limits and the dollar limit on SEP contributions.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) placed self-employed businesses on an equal footing with corporation by making contribution and benefit limits the same for all pension plans. Under TEFRA, so-called "top heavy" plans—those in which more than 60 percent of benefits were going to "key" employees—were required to provide minimum benefits or contributions to rank-and-file workers, provide for faster vesting standards, and placed stricter limits on allowable benefits for key employees.

The pace of legislative change continued with the Deficit Reduction Act of 1984 (further reducing the limits on maximum plan contributions and benefits), the Retirement Equity Act of 1984 (reducing the minimum age of plan participation from 25 to 21), and the Single-Employer Pension Plan Amendments Act of 1986 (restricting the terms under which pension plans can terminate and increasing the termination insurance premiums that single-employer plans must pay).

The Tax Reform Act of 1986 (TRA '86) marked a reversal in U.S. retirement policy, reducing incentives for retirement savings. It capped the amount of allowable individual pretax contributions to a 401(k) at $7,000 (indexed), significantly reduced the overall limits on both defined benefit plans and defined contribution plans, narrowed the circumstances under which money can be withdrawn from defined contribution plans, increased taxes on preretirement withdrawals in some cases, restricted income averaging, and modified the tax treatment of capital gains.

Pension changes were also included in budget bills in 1986 and 1987. In 1986, plans were required to continue benefit contributions or accruals regardless of age for workers participating in defined contribution or defined benefit plans. In 1987, the single-employer defined benefit termination insurance premium was raised and funding rules were changed substantially.

Pension legislation has served to increase the security of benefits for those with coverage, and it has created many jobs. It has not led to an increase in the proportion of workers covered by pension plans.

During the budget negotiations of 1989, various proposals that would affected pensions and retirement income, including those calling for joint trusteeship, user and exit fees, Pension Benefit Guaranty Corporation (PBGC) premium increases, and ERISA penalty fees, were carefully considered. Many of these proposals were not enacted in 1989, but continued scrutiny of their administration and design is anticipated in 1990.

Trends in Pension Coverage

Employer-sponsored pension plans represent an important source of retirement income for most working Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement (CPS EBS), in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of all these participants, or 32 million workers, were entitled to a benefit at retirement.

Defined benefit plans have historically been the cornerstone of the private pension system with an estimated 38 million participants and beneficiaries, and $1.36 trillion in trusteed assets. But recently, an increased number of defined benefit terminations, a slower rate of defined benefit plan formation, and fundamental redesign of traditional "final pay" defined benefit plans into "cash balance" defined benefit plans suggests that U.S. employers are reevaluating the appropriateness of these plans.

Increasingly, there has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975 (chart 1).

The nature of this apparent shift in emphasis from the traditional defined benefit plan to the newer defined benefit and defined contribution plans has been a source of continued evaluation. Experts offer varying observations on the potential reasons: increased regulation of traditional defined benefit plans, increased administrative cost due to regulation, an increasingly mobile work force who may be better served with a "cash balance" or defined contribution plan, federal tax laws that have created incentives for new defined contribution arrangements, and the lowering of basic income tax rates, which has reduced the effective tax incentive for plans.

Many maintain that government regulation has made defined benefit plans too costly, prompting plan sponsors to offer no pension plan or to shift to generally less burdensome defined contribution plans (see EBRI, *What is the Future of Defined Benefit Pension Plans?*, 1989).

One of the most significant trends in pension coverage has been the tremendous growth of 401(k) plans over the past decade. More than 27.5 million workers were covered by 401(k) plans in May 1988, up from 7.1 million in May 1983. These figures represented 24.2 percent and 7.1 percent of all workers, respectively. Participation grew from 2.7 million workers (2.7 percent of all workers) in 1983 to 15.7 million (13.8 percent of all workers) in 1988.

An increasing number of workers are relying on 401(k) plans as their primary employer-based retirement plans, especially 401(k) participants at small firms. The 1988 CPS EBS found that more than 49 percent of 401(k) plan participants reported that this was their primary employer pension plan. Among 401(k) participants working for employers with 250 or more employees, 43.5 percent had a primary 401(k); this proportion increased to 79.5 percent for 401(k) participants in establishments with fewer than 10 employees.

The future of 401(k) sponsorship and participation is uncertain. Passage of TRA '86 does not appear to have slowed 401(k) plan growth, although that possibility remains as more restrictive provisions of the law become fully effective. Final regulations addressing hardship withdrawals and loans, released in August 1988 and July 1989, respectively, could arguably be a deterrent to employee participation and create administrative problems for some employers. However, this cannot be assessed fully until the provisions have been in effect longer.

Pension Coverage by Small Employers

The gap in private-sector pension coverage for workers appears to be largely among small employers. The latest data indicate that more than 68 percent of full-time employees in companies with 250 or more employees participate in retirement plans, while, by contrast, only 16 percent of full-time employees in companies with less than 24 employees do so (chart 2).

Some members of Congress and other policymakers have indicated concern about potential costs to society and to future retirees themselves if employer-sponsored pension coverage fails to continue the expansion of the past 15 years, supplementing Social Security and private savings.

To meet this challenge of providing additional coverage, a number of legislative proposals specifically aimed at small employers have been introduced in Congress in recent years. But the benefits that small employers provide must be viewed within the context of the nation's retirement income system and the economy as a whole if we are to judge whether national needs are being met.

The Economics of Regulation

In a recent EBRI study, *Pension Policy and Small Employers: At What Price Coverage?*, author Emily Andrews examines the impact of pension legislation on pension plan growth based on the economic theory that employers will balance the costs of instituting a pension plan against the benefits they receive.

According to Andrews, the favorable tax treatment provided pension plans reduces the costs of plan sponsorship. Since pension contributions are treated as current business expenses, funded plans are a good business decision. Pension plans are also regarded favorably by employees because they can defer individual income taxes on pension contributions until retirement. By making benefits more secure, ERISA may have increased the demand for pensions among employees. The provisions that may have made pension coverage more attractive include funding standards, PBGC insurance, vesting and participation standards, and better information about plans through summary plan descriptions.

Since pension law encourages different types of plans, employers can match pension sponsorship to their business situation. In particular, developments such as Keogh plans, 401(k) plans, and SEPs may have made tax-favored pensions more attractive to small employers.

Other provisions may impose additional costs on employers, however. Funding and fiduciary standards reduce the employer's flexibility to finance corporate expansion through retained earnings. PBGC premiums are a direct cost imposed on a per participant basis for defined benefit plans. Plan descriptions and other reporting requirements also directly increase the administrative costs of the plan.

Restrictions that cap contributions and benefit payments also make pension plans less appealing, particularly for those motivated by the tax deferral on contributions.

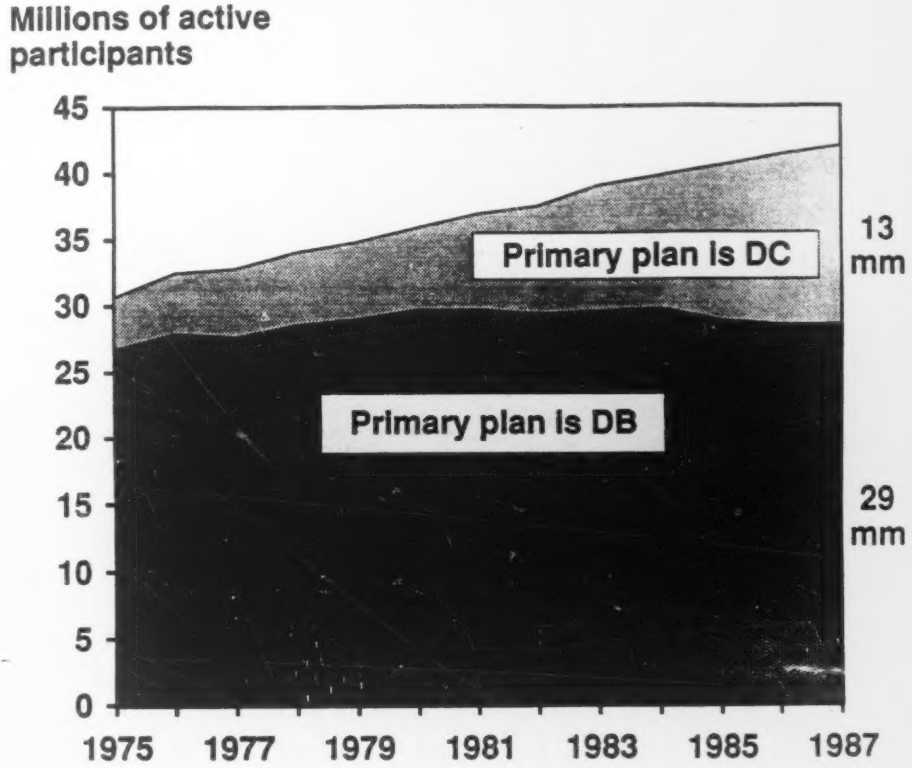
The Retirement Equity Act of 1984 also may have raised the costs of plan provision for some employers. The required five-year break-in-service provision increases recordkeeping costs, particularly in firms with high employee turnover.

Conclusion

A constant theme reiterated by employers is their concern about regulatory complexity and frequency of legislative change. Large employers can and do afford the costs, which can be small on a per employee basis. For small employers, however, complex regulations require costly expert advice in establishing and maintaining a pension plan and the costly revision of plan documents. Changing regulatory and enforcement approaches by regulatory agencies add to both the cost and confusion. Thus, no matter what the nature of the change, if it is frequent or complex, it will be costly. When combined with laws and regulations that make it increasingly difficult to fund a plan, attractiveness fades further. And, when considered against other tax preferences, in light of today's low tax rates, the reluctance of small employers to expand pension coverage may be quite understandable.

Chart 1

Growth in private pension participation is all DC

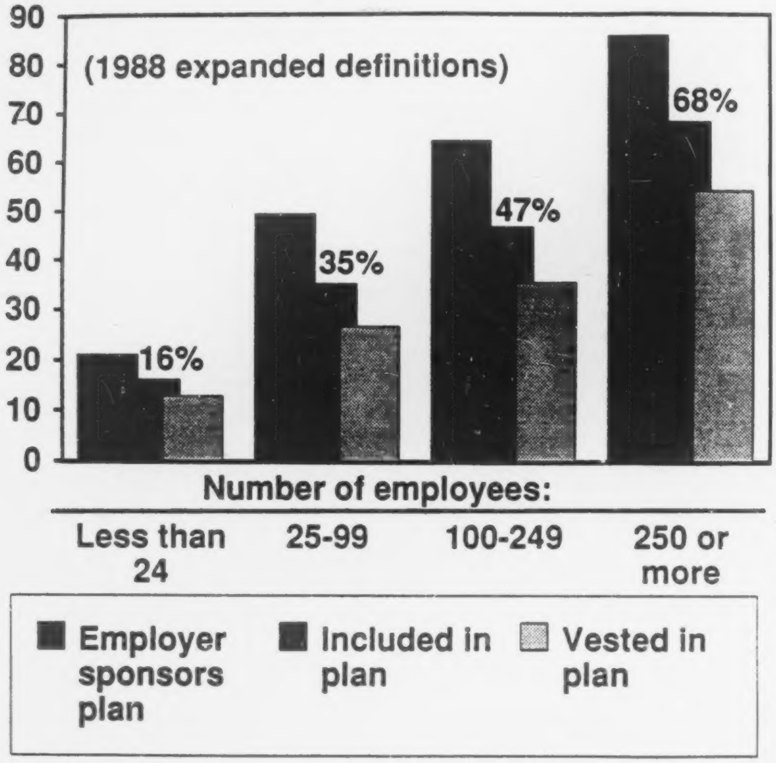


Source: Employee Benefit Research Institute

Chart 2

Firm size remains a key factor in pension coverage

Percentage of private-sector, full-time workers in 1988



Source: Employee Benefit Research Institute

Committee on Small Business
U.S. House of Representatives
June 5, 1990

Hearing on Pension Issues

Testimony of Roy A. Schotland, Professor of Law, Georgetown U.,

Joint Trusteeship? A Red Herring Concealing the Needed Reform

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SUMMARY of TESTIMONY:

1. Small business's pension plans are bound to be fewer and weaker if the private pension system fails to command widespread popular support. That support is bound to depend primarily on how well private pension plans provide benefits--but it undeniably depends in part on whether private plans are managed purely paternalistically.

2. Giving participants and retirees *some* role in plan governance will raise none of the concerns provoked by the pending proposal to mandate joint boards, but will assure the two obviously needed corrections of the present system:

--Participants' retirement security will be managed with their views on the table.

--Participants will be far better informed of how *their* plan is being managed.

The current governance structure of corporate plans is a paternalistic relic of the era in which a career of faithful service was ended with a gold watch. At least since 1974, pensions are not gifts. Can plans really be managed for the "exclusive benefit" of participants, as our legislated litany rightly requires, if their governance is completely exclusive of participants?

* * * * * * *

Chairman LaFalse has specifically requested comment on pending proposals "that employee representatives comprise half of a pension plan's board of directors".

"Who's afraid of the lunchpail trustee?" So far, "afraid" or flatly opposed are a clear majority of the U.S. House and an apparently unbroken chorus of pension people affiliated with corporate sponsors. On the other side, supporting Congressman Visclosky's proposal, we've had an array of labor leaders and academics.

As so often, we have here a noble goal and blunderbuss proposal to attain it, provoking brick-wall opposition and, on both sides, overblown rhetoric and a range of only marginally relevant facts. As the leading bi-weekly Pensions & Investments pointed out editorially (4/12/90, p. 16), one advocate of joint representation "speaks of corporations in terms of 'darkness', 'monopoly' and 'malfeasance'". Benighted brickbats proliferate on each side.

Three weeks ago, Congressman Visclosky reported on a series of meetings aimed at finding common ground for compromise. (Reportedly one of the issues being discussed is whether the bill "should be permissive or mandatory", which is just the same as whether there should be a bill at all.)

Surprisingly, no one has spoken out for participant representation on the one hand, but against the extreme of joint representation on the other.

Rather than repeating the pros and cons about the Visclosky proposal, let's focus on eight points, as lean and rhetoric-free as I can put them:

1. Multi-employer plans, with joint boards, are so different from corporate plans in so many ways that we should put aside the differences, and focus on whether we think the current governance structure of corporate plans is ideal or can be improved.

2. Public plans also are of course very different from ERISA-covered plans. But the fact that their boards are diverse, with so many assuring some participant representation (sometimes joint boards, often only a minority representing participants), surely calls into question ERISA's procrustean treatment:

--joint boards for multis,

--zero participant representation elsewhere,

--and, nothing else.

3. ERISA-covered pension assets must, by law, be managed for the "exclusive benefit" of retirement security. Since the pension liability is the sponsor's, it is understandable that _control_ of those assets has remained the sponsors'.

4. Given the primacy of the "exclusive benefit" goal, surely it is questionable (I find it inconsistent and foolish, or at least anomalous and self-defeating) that the people whose "exclusive benefit" is at issue are entirely excluded from plan governance.

5. Battling about "control" and joint representation is a red herring. The real question is whether pension plans would gain

or lose if participants had some role in their governance. ERISA is loaded with provisions to prevent conflict-of-interest abuses and to assure adequate disclosure to plan participants, but nothing in the plans' governance structure helps meet those concerns. Further, ERISA disclosure, though today's time limits bar developing the point, has been monumentally ineffective, even wasteful. But effective disclosure remains one of our most powerful and least intrusive ways to improve plan management.

6. If participants have some representation on plan boards, there may or may not be better investment or other changes, but there will be two certainties: plans' boards will be more aware of participant views, and participants will be more aware of their plans' operation and strengths or weaknesses. Plans that are well run have nothing to lose and are likely to produce greater employee satisfaction. Plans that are less well run will enjoy one more mechanism pushing them toward shaping up.

7. Every ERISA-covered plan above X size (in assets or participants) should have on its board at least one or two participant representatives, and also at least one retiree representative (unless the retirees are included in the process of selecting the participant representatives). Rather than trying once again to perfect the world by close of business tomorrow, the requirement should be phased in, starting with, say, two years experience at plans in the largest quartile in

size, then broadening to cover all plans above X size.

As for how those representatives shall be selected, we can set several models and let sponsors pick whichever fits best.

8. Since defined contribution plans impose all investment risk on participants, there the case for including participants in governance is obviously stronger. Indeed, there the lack of participant representation is indefensible-- it almost certainly exists only because ERISA gives unduly little attention to DC plans. Correcting this should not be delayed by fighting over whether governance will be shared 50-50.

For DC plans, at least about one third of the board should be participant representatives. (Retirees have little or no continuing interest in such plans and needn't be represented.)

Summing up, two points:

1. Small business's pension plans are bound to be fewer and weaker if the private pension system fails to command widespread popular support. That support is bound to depend primarily on how well private pension plans provide benefits-- but it undeniably depends in part on whether private plans are managed purely paternalistically.

2. Giving participants and retirees some role in plan governance will raise none of the concerns provoked by the pending proposal to mandate joint boards, but will assure the two

obviously needed corrections of the present system:

--Participants' retirement security will be managed with their views on the table.

--Participants will be far better informed of how their plan is being managed.

Pensions & Investments put this well: "This would no doubt improve communication and remove some of the mystery and suspicion that surrounds the investment of pension fund assets." (Editorial, Aug. 7, 1989, p. 10.)

The current governance structure of corporate plans is a paternalistic relic of the era in which a career of faithful service was ended with a gold watch. At least since 1974, pensions are not gifts. Can plans really be managed for the "exclusive benefit" of participants, as our legislated litany rightly requires, if their governance is completely exclusive of participants?

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